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Spring 2020

Exchange

Association for Financial Professionals' Quarterly Magazine

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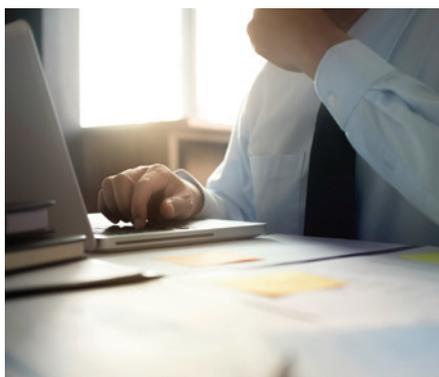
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Headquartered outside of Washington, D.C. and located regionally in Singapore, the Association for Financial Professionals (AFP) is the professional society committed to advancing the success of treasury and finance members and their organizations. AFP established and administers the Certified Treasury Professional® and Certified Corporate FP&A Professional® credentials, which set standards of excellence in treasury and finance. Each year, AFP hosts the largest networking conference worldwide for more than 7,000 corporate financial professionals.

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JIM KAITZ, PRESIDENT & CEO

STAYING AGILE THROUGH CONSTANT VIGILANCE

Dear AFP Members,

How can you stay ahead of risk in today's uncertain world? With seemingly never-ending challenges like cyberattacks to geopolitical upheaval, the ability to stay agile in this environment is top of mind for all of us.

Recently on the AFP Conversations podcast, I spoke with Leo Tilman and General Chuck Jacoby of the advisory firm Tilman & Co., co-authors of the book, "Agility." Despite having very different backgrounds, their views on agility are quite similar. You see, their definition of agility is the "organizational capacity to detect, assess and respond to change in ways that are purposeful, decisive and grounded in the will to win."

The *2020 AFP Risk Survey* revealed some key changes in the risk landscape. Fully 53% of respondents identified cyberrisk as the toughest risk to mitigate. That's a far cry from the 12% who cited cyber as a difficult risk to handle, just a decade ago. And while most respondents have a formal process in place to assess and report risk, 51% of them acknowledged that forecasting risk is becoming more difficult. That trend is expected to continue through 2022.

So, as our survey acknowledges, it's not going to get any easier. Risks can arise on the edges, even with copious amounts of data at our fingertips. The entire organization needs to be involved in that process of risk detection. Whenever someone sees something out of the ordinary—even if it proves

insignificant—they should feel empowered to call attention to it.

It's the responsibility of leadership to foster this culture of vigilance. Leaders need to drive that effort and communicate it across the organization, so that everyone knows their role and is attuned to risks that could impact the organization. A new guidance from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) also stresses this idea, imploring corporate leadership and the board to integrate risk analysis into strategic planning.

We tend to address risk in a reactive way, and we need to be more proactive than we are today. It's not enough to simply identify the risks. We also need to gauge how risks are evolving and anticipate how those evolving risks will touch areas that they never have before. Someone needs to lead that effort. Is it the CFO? The treasurer? The chief risk officer? That responsibility may differ, depending on the organization. But someone needs to take on that role directly; it can't be vague. Otherwise, you'll just open yourself up to—you guessed it—more risk.

Sincerely,

Jim Kaitz
President and CEO

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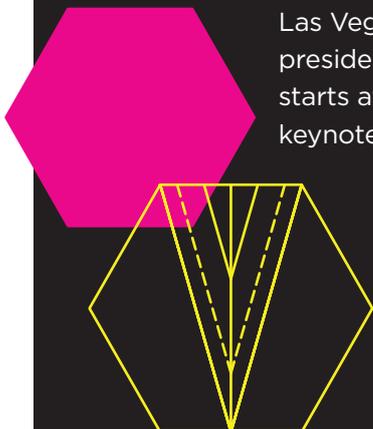
Shaquille O’Neal, Tony Hawk and
Amy Webb to Keynote AFP 2020

STAFF WRITERS

AFP 2020, the most important event in treasury and finance, is elated to announce a powerhouse lineup of keynote speakers: Shaquille O’Neal, Tony Hawk and Amy Webb.

Fifteen-time NBA All-Star player and entrepreneur, Shaquille O’Neal, will be the opening speaker at AFP 2020, October 18-21, in Las Vegas. Skateboarding icon and philanthropist, Tony Hawk, will close the event as the Tuesday afternoon keynote. And Amy Webb, quantitative futurist and a bestselling, award-winning author, is this year’s MindShift keynote.

“This October, thousands of treasury and finance professionals will descend upon Las Vegas to connect with their peers and discover new insights,” said Jim Kaitz, president and chief executive officer of AFP. “An exceptional conference agenda starts at the top, and we couldn’t be luckier having Shaq, Tony and Amy as this year’s keynote speakers.”





Shaquille O'Neal Biography

Infamously known by one name alone—Shaq's athletic career spanned two decades, bringing him to an iconic status that earned him sport's highest honors, including induction into the NBA Hall of Fame. In his transition from sports, Shaq has established himself as an influential media personality and businessman, ranking among "The 100 Most Creative People in Business" by Fast Company magazine. In addition to being an early investor in companies such as Google, Shaq has managed an increasingly robust personal brand that includes television shows, a shoe line and social media/tech products.

Shaq will speak to AFP 2020 attendees about the power of believing in and investing in yourself. As an athlete and business leader, Shaq is ready to bring his inspiring journey to life in this dynamic conversation. Providing what he dubs "Shaqisms", Shaq delivers actionable insights—for business and personal life—on being resilient, fostering collaboration, committing to life-long learning and his decision-making process for netting high-impact business outcomes.



Tony Hawk Biography

Tony Hawk began his professional skateboarding career at age 14, and by 16, he was widely considered to be the best skateboarder on earth. Today, his adept business skills have allowed Hawk to establish an empire that includes a billion-dollar video game franchise, successful businesses such as Birdhouse Skateboards, Hawk Clothing, and the Tony Hawk Signature Series of sporting goods and toys.

At AFP 2020, Hawk will speak to attendees about maintaining authenticity through difficult decisions. In their role, treasury and finance professionals need to maintain their own authenticity and commitment to professional growth to ensure that they remain trusted advisors to the business. Hawk's experience balancing his authentic self with the pressure of "selling out" is what has allowed him to embrace his gut sense of doing things, while remaining true to what has led to his overwhelming success.



Amy Webb Biography

Best-selling author of *The Big Nine* and *The Signals Are Talking*, Amy Webb is a quantitative futurist and a professor of strategic foresight at the NYU Stern School of Business. She is also the Founder of the Future Today Institute, a leading foresight and strategy firm that helps leaders and their organizations prepare for complex futures. Named to the 2017 Thinkers50 Radar list of management thinkers most likely to shape the future—and winner of its 2017 Distinguished Achievement Award—Webb is making an impact on today's Fortune 500 and Global 1000 companies, government agencies, large nonprofits, universities and startups worldwide.

As this year's AFP MindShift Keynote, Webb will explain how treasury and finance leaders can harness a futurist's strategic tools to benefit their organizations. Attendees will learn how to think like a futurist, rethink risk, and how to know when to act. Webb will share future scenarios of emerging technologies impacting corporate finance to help attendees discover their own ability to not only forecast what's on the horizon, but how to create their own preferred future today.

For more information about AFP 2020, please visit www.AFP2020.org. General housing for AFP 2020 opens March 19, please visit www.AFP2020.org/housing to make your reservation.



Threat Evolution

AFP RESEARCH

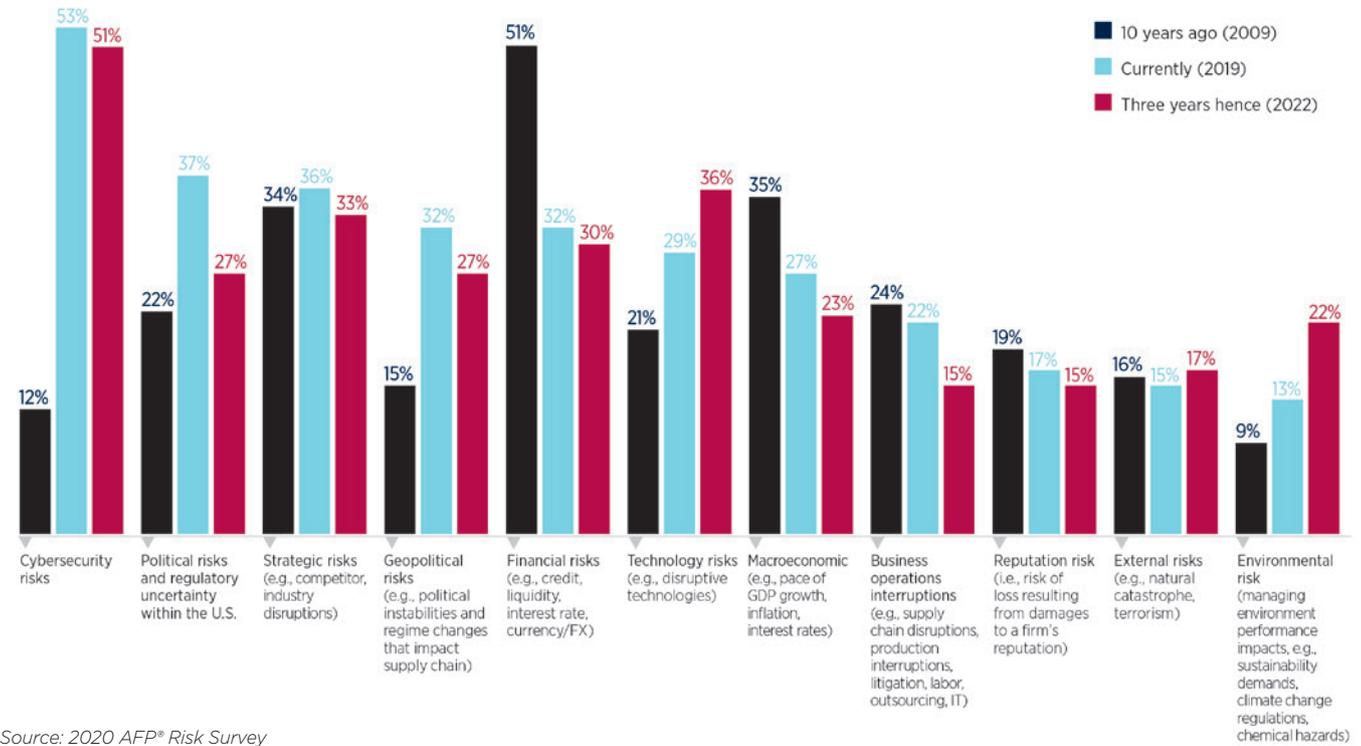
Cyber risk is financial professionals' top concern

Treasury and finance professionals believe that cyber risk is the most challenging risk to manage and will continue to be for the foreseeable future, according to the *2020 AFP Risk Survey*, supported by Marsh & McLennan.

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Risks That Were/Are/Will Be the Most Challenging to Manage

(Percent of Respondents Who Rank Risks in Top Three)



Source: 2020 AFP® Risk Survey

Cyber risk continues to increase

Cyber risk across organizations has become rampant in the last decade. In a poll of nearly 365 practitioners, the survey found that 53% report that cybersecurity risk is currently the most challenging risk to manage. Additionally, fully 51% of respondents believe that three years from now the task of managing cybersecurity risks will continue to be the most complex risk to manage. Cybersecurity risks are an example of the evolving risk landscape; a decade ago, only 12% of survey respondents cited cyber risk as difficult to control.

Not only are treasury professionals currently concerned about cybersecurity risks, they anticipate that in 2022 they will be focusing substantial efforts on controlling these risks. Responsibility and accountability for cyber risk have gone beyond IT departments, and across the organizations stakeholders are cognizant of the impact of cybercrimes. Although organizations

are ramping up systems internally, they are faced with controlling increasingly malicious cyberattacks and a greater increase in the number of those committing crimes.

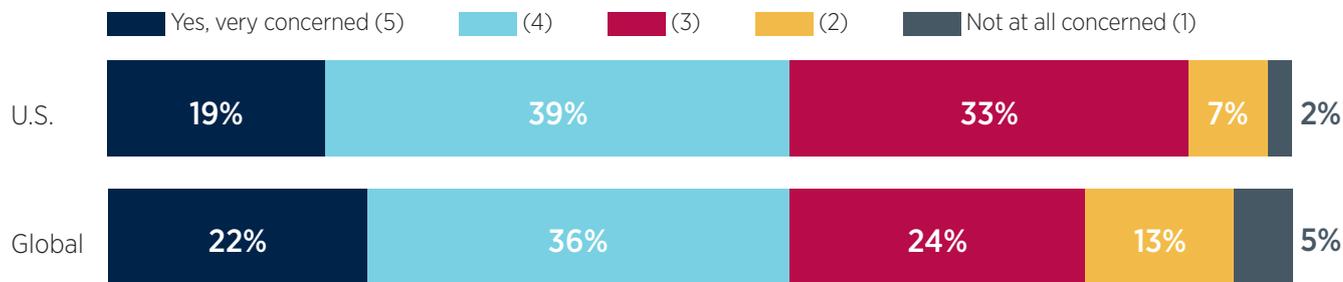
Risks poised to impact earnings

Survey results also revealed the risks that financial professionals believe will have the greatest impact on earnings in the next three years. Strategic risks (e.g., competitor, industry disruptions, etc.) topped the list (40%), followed by financial risks (35%), political risks and regulatory uncertainty within the U.S. (33%), and macroeconomic risks (31%).

Strategic risks can be managed through investment in key business areas, diversification of business prospects, mergers/divestitures and/or building out the supply chain to better match footprint efficiencies. There is an increasingly frequent link between strategic risks and technology disruption risks, e.g., tech-enabled fast adopters or new entrants changing competition dynamics.

Level of Concern About Upcoming Economic Uncertainty

(Ratings on a 5-to-1 scale, with 5 = very concerned, 1 = not concerned at all) (Percentage Distribution of Organizations)



Source: 2020 AFP® Risk Survey

With 2020 being a presidential election year in the U.S., there is uncertainty around whether or not there will be a change in administration and the impact any such change could have on the regulatory framework. This explains the sentiment that political and regulatory risks will have an impact on organizations’ earnings in the next three years.

Additionally, there is some concern that the U.S. economy may be facing some headwinds, and interest rate cuts by the Federal Reserve Board late last year have done little to allay the fears of business leaders about financial and macroeconomic risks impacting organizations’ earnings. Fully 57% of treasury professionals revealed that they are concerned about upcoming economic uncertainty in the U.S., with 19% indicating that they are very concerned. Similarly, 58% of corporate practitioners said they were nervous about the global economy.

At the time the survey was being conducted, negative interest rates prevailed in Europe, Brexit was unresolved, tariffs were impacting businesses’ bottom lines and the China trade war continued to play out. Since then, however, a general election in the UK gave the Conservative Party a solid majority in Parliament; consequently, plans for Brexit continue. Meanwhile, the U.S. and China have reached a “phase-one” deal, which will reduce some tariffs in exchange for more Chinese purchases of American products.

Financial professionals adapting

Risk assessment is a significant aspect of the risk management process. Performing

thorough and regular risk assessments can help managers identify and detect risk at an early stage, thereby preventing extensive damage. This can assist business leaders’ planning so they can adjust to a constantly changing risk atmosphere.

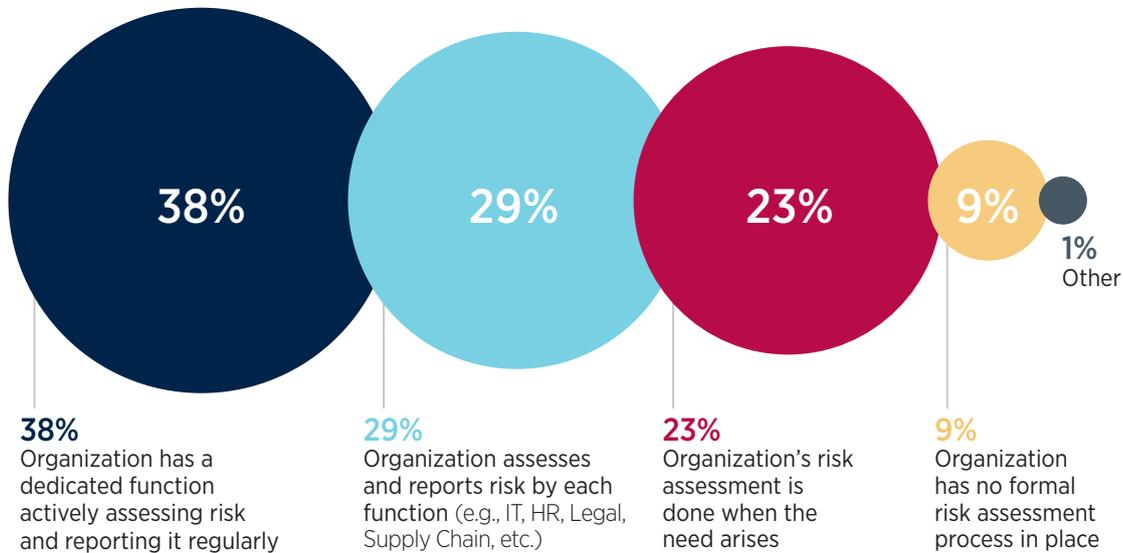
As the risk landscape has continued to evolve, companies have been adapting accordingly, performing thorough and regular risk assessments. Fully 38% of organizations have a dedicated function actively assessing risk and reporting it regularly, while 29% have a process through which individual functions assess and report risk. Other companies are more informal in their risk assessment process, with 23% stating their organization assesses risk only when the need arises. Only 9% of respondents said that they have no formal risk assessment process in place.

“Today, organizations have to grapple with multiple risks,” said Jim Kaitz, President and CEO of AFP. “Cyber risk flew under the radar a decade ago, but financial professionals now understand that they will still be struggling with controlling this risk for the foreseeable future. Over time, we are sure to see risks continue to evolve and risk managers will need to adapt accordingly.”

“While financial leaders are better prepared to manage known risks, the survey data points to the need to improve the ability to systematically identify new, emerging risks and analysis of known risks, such as cyber and extreme weather,” said Alex Wittenberg, Executive Director, Marsh & McLennan Advantage. “Few organizations

Organized to Assess Risk

(Percentage Distribution of Organizations)



Source: 2020 AFP® Risk Survey

have adopted formal processes for engaging senior leadership and the board in a discussion of how an increasingly uncertain environment will impact strategy decisions.”

Conclusion

Findings from the 2020 AFP Risk Survey indicate that risk management continues to be a top priority. The general sentiment among financial professionals is that their organizations are prepared to manage risks. Companies are actively looking ahead and appropriately concerned about upcoming economic uncertainty and preparing for any volatility that might arise. Survey respondents agree that their organizations are preparing treasury and finance teams to face risks and equipping them with the tools needed to efficiently manage those risks. After the recession of 2008, financial leaders are not taking any chances; they are cautious and planning for the unexpected. The vulnerability of organizations a decade ago resulted in them being seriously affected by the recession. In addition, organizations are structured to effectively assess risk, either by creating a separate function solely responsible for assessing risk or by assigning individual functions with the task of assessing risk.

But as much as organizations plan for risk, the unexpected will always occur. For example, cybersecurity wasn't on the radar of financial leaders a decade ago, but over time risk managers have found it to be the most difficult risk to manage. Organizations are planning and investing in methods to keep ahead of risk, but cybercriminals aren't easy to outsmart.

The key to safeguarding organizations from risk events is effective and comprehensive risk management. This involves ensuring proper risk identification and assessing deficiencies/gaps in coverage. Determining those risks that are predictable, unpredictable, the likelihood of an occurrence of an event, and the severity of its impact are necessary. Shoring up coverage for those risks that have increased uncertainty and a higher likelihood of disruption is vital.



Results are available at
www.AFPonline.org/risksurvey.

RISK

AMOL DHARGALKAR

Point of No RETURN



Post Brexit, huge questions remain for treasury and finance

After years of contentious debate, failed votes, and elections, the United Kingdom finally “exited” its arrangement with the European Union on January 31, 2020. While it ultimately happened with little fanfare or drama at the end, the country remains split on Brexit. Stories of celebratory parties occurring within feet of somber events commemorating the end of the UK/EU marriage were common. Despite the fanfare, though, Brexit has not truly come to fruition—the process is far from complete.



Transition period

So, what has happened already and what happens next? Technically, Article 50, the legal mechanism that allows for members to leave the European Union, expired on January 31. Practically, this means that the UK can't change its mind now. If it wants to re-enter the EU, it must apply for membership and have all then-current members accept it.

The UK will now live under the transition agreement negotiated with the EU, requiring it to continue to comply with all EU rules until December 31, 2020. Since the UK is no longer a member of the EU, it has no say on changes in the rules under which it must live through the remainder of this year. More importantly, the two parties have under 11 months to finalize an agreement of how they will access one another's markets and under what terms.

This is an aggressive timeline by anyone's reckoning. The original Withdrawal Agreement negotiated by former Prime Minister Theresa May contemplated a 21-month transition period. Even this was billed as ambitious. Historically, the average time required to negotiate a trade deal between the EU and a third country has been 48 months. Among the quickest of these were negotiations with South Korea and Vietnam, each of which took a little under three years—and the much-touted Canada deal took seven.

In theory, the December 31 deadline could be pushed back. The terms of the Withdrawal Agreement between the UK and the EU allow for an extension to the transition period if this is agreed upon by June 30. However, the current political environment in the UK makes this extremely unlikely. Prime Minister Boris Johnson was elected with a mandate to “get Brexit done” and has since written the December 31 cut-off into UK law. Any delay to this would require new legislation, which has little to no support in the governing Conservative Party. In any case, an extension request after June 30—only four months after trade negotiations are due to start—would require the unanimous agreement of all 27 EU member states.



More important than trade volumes are the complex links between the two economies, from “just in time” manufacturing supply chains to financial contracts.

Critically linked

Both parties have strong incentives to reach an agreement that gives each access to the other’s markets free of tariffs and quotas. The headline figures alone are compelling for both sides: the EU accounts for 45% of UK exports, while the UK accounts for 8% of those from the EU. But more important than trade volumes are the complex links between the two economies, from “just in time” manufacturing supply chains to financial contracts. The knock-on effects of any deal (or lack thereof) that breaks, or even weakens, these critical links would significantly outweigh a simple loss of export revenue—for both sides.

The flip side of this interdependence is the vast scope demanded of any trade deal that can be considered adequate. Negotiations will take place across everything from food standards to banking regulations. Largely obscured by emotive headlines about more tangible (but less economically important) industries like fishing, a battle over the future of financial regulation has been rumbling on ever since the 2016 recognition.

Already, the EU is looking to modify the updated Markets in Financial Instruments Directive (MiFID II) in ways that the UK previously rejected, underlining the challenge

ahead for the two parties. Meanwhile, the UK government’s current proposal for “outcomes-based equivalence” for financial services rules looks suspiciously similar to Theresa May’s suggestion of “mutual recognition,” which was rejected out of hand by the EU.

And yet the other alternative on the table—an “equivalence regime” under which UK financial services firms would retain access to the EU market only if the UK kept in place regulations that were equivalent to EU ones—is fraught with difficulties. Not only would it effectively make the UK a rule-taker from a regulatory perspective, it would in fact cover only around a third of financial services activities. Moreover, it could be withdrawn by Brussels with only 30 days’ notice, which doesn’t provide the security that financial firms are looking for.

Of course, how to implement all these agreements with respect to the border between the Republic of Ireland (an EU member) and Northern Ireland (part of the UK) remains a contentious and emotional issue as well. The soft border dividing the island of Ireland represented a burying of many of the issues that had driven a long and bloody conflict, in the hope that future generations would be better able to resolve them. Now, they are set to be unearthed barely two decades after the Good Friday Agreement brought the conflict to a close.

All in all, a no-deal Brexit (now referred to by the UK government as an “Australia-style deal”) is still a distinct possibility.

Impact on treasury

What does this mean for corporate treasury and finance professionals? Despite the seemingly large step taken in late January to exit, the UK remains in a state of transition and uncertainty. This may have a disproportionate impact on capital markets and exchange rates, leading to lower capacity for financing and greater volatility on GBP specifically. The Bank of England stands ready to support the UK economy through the Brexit process, and has neither cut nor raised rates since mid-2018, nor has it expanded its quantitative easing program since 2016.



What does this mean for corporate treasury and finance professionals? Despite the seemingly large step taken in late January to exit, the UK remains in a state of transition and uncertainty.

Should the Bank of England cut rates or otherwise engage in the markets to drive medium-term rates lower, firms may find it cheaper to issue debt in U.S. dollars and use cross-currency swaps to convert it synthetically to sterling. Right now, firms can utilize these derivatives to save nearly 100 basis points per year relative to USD debt. Should USD rates rise while UK rates fall, these savings could become even larger, and rival savings are seen in the EUR (200 bps).

Secondly, despite the possibility of more drama to come, and the drama that has already happened around Brexit, GBP-USD currency option volatility is at nearly six-year

lows, thus reducing the cost of buying options on GBP. For those looking to engage in significant mergers, acquisitions, divestitures, or capital expenditures in the UK, options may provide a tool not commonly utilized across treasury teams to mitigate risk.

While those living through Brexit would like nothing more than certainty and finality on the process, negotiations will take far longer to reach such a point. In the meantime, treasury and finance professionals will need to remain vigilant for opportunities to minimize risks and add value to their organizations.

Amol Dhargalkar is managing director for Chatham Financial.



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The Masterplan

RIAN BARTLETT, CTP

Developing a corporate funding strategy

In order for any corporate treasury department to successfully pursue its strategic objectives, it must be sufficiently funded—i.e. have the right amount of money, at the right time, and in the right currency. This requires putting a funding strategy in place that addresses the optimal funding mix and the best source of funds, given the corporate's operational and strategic investment needs.

Although there is not a "one-size-fits-all" funding strategy, general principles can be applied. These are discussed in the following four steps.

Treasury must understand the corporate strategy, as it forms the basis upon which investment needs are determined.

1

Understand the overall corporate strategy

Treasury must understand the corporate strategy, as it forms the basis upon which investment needs are determined. It typically consists of two components.

The **business strategy** (business profile) covers the company's products, the markets it operates in, and the extent to which the focus will be on growing the operations. There are several aspects of the business that will be particularly relevant to the funding strategy.

For businesses that are capital intensive or that focus on product innovation, there is typically a delay between when cash is spent and generated by the project or product. This means committed and probably longer tenor, nonbank funding (diversification) are needed to ensure completion and delivery as promised.

If the focus is to grow the business via acquisitions, then the banking group must be sufficiently large and strong to raise an acquisition facility, and the ability to refinance the facility in the debt capital markets becomes important.

A company with geographically diversified operations may require funding in non-major currencies. Projects in higher-risk countries also may require project or asset-specific funding in order to mitigate the project and/or country risk.

The **financial strategy** (financial profile) aims to ensure that the strategic objectives of the company can be executed in a disciplined and effective manner that enhances overall shareholder value. The financial strategy parameters (e.g., target credit rating and financial ratios), take into account the company's capital structure, financial strength and size, and are important to consider in formulating the funding strategy.

2

Determine the funding requirement

Taking into account the direction provided by the corporate strategy, the company can complete a cashflow forecast that should ideally cover a five-year time horizon, but with the first 12 to 24 months (ideally) being broken up in monthly brackets, so that the short to medium-term funding requirement can be determined more accurately.

Treasury needs a particularly good understanding of the forecast, for example:

- How predictable, cyclical or seasonal the cash flows are
- Cash visibility and availability (i.e., to what extent the forecasted cash flows are available in full to the center). This could be an issue if some operations are in countries where local central bank regulations prohibit the immediate remittance of cash to the center.

Based on the above, appropriate adjustments must be made to the forecast to ensure it is as accurate as possible. The adjusted forecast will be used to determine the amount of funding required, when and where the funding is required and the reason(s) for the funding, which can include operational shortfalls, working capital and trade finance-related funding, funding an acquisition or project, and repayment of maturing debt.

3

Assess which funding sources to use

The choice of funding source will be driven primarily by the amount to be funded and the reason for the funding. Ideally, the funding source(s) selected must allow the corporate to:

- minimize the cost of funds
- raise funds quickly if required (speed of execution)
- facilitate the effective management of the debt maturity profile (refinancing risk)
- access it, even if the corporate is under pressure (including adverse market conditions) (availability)
- avoid onerous documentation and disclosure requirements (simplicity)
- avoid over-reliance on bank funding (diversification)
- rely on it given the potential competition for the same funding source (peers, similar rated corporates) (capacity)

The right mix of funding sources, can include any of the below or more likely a combination:

- equity, including convertible bonds – typically if large amount to be raised, or further debt not advisable
- **bank funding** - uncommitted (e.g. bank overdraft), committed (e.g. revolving credit facilities, term loans), specific (e.g. bilateral facility, syndicated facility)
- **corporate bonds (including private placements)** - achieve maturities longer than those typically offered by bank funding, and achieves diversification of the investor base.
- **project finance** - may be required by partners in a project, or if country risk must be mitigated.
- **receivables (asset based) financing** - securitisation, factoring etc
- **other** - commercial paper (need back-up facility)

The funding sources selected may also be impacted by **legislation, regulations and trends**, for example, banks may become increasingly selective in lending funds for the building of new coal plants (climate change). Consequently, for a coal producer to rely solely on bank funding will be inappropriate.

At this point treasury should also have a good view as to the level of complexity of the funding to be undertaken.

4

Apply basic funding principles, then set the objectives

Basic principles to consider in developing the funding strategy, includes:

- ensure funding documentation is always updated so that markets can be accessed quickly if required
- a core funding requirement should not be funded with short-term facilities (e.g. commercial paper) unless cash flows are stable and predictable
- the more unpredictable the cashflows are, the greater the need to have a sufficient liquidity buffer and access to diversified funding sources
- if the funding requirement is large and recurring then access to long-term funding sources (e.g. debt capital markets) becomes important
- do not extend the maturity profile too far if the cash generation is expected to be strong, as the early repayment of long-term debt may not be possible, or it may be costly (important when deciding on structure of acquisition facility)
- strong and transparent relationships with providers of capital increases their support

A funding strategy will have to be managed in line with and measured against agreed objectives. Below are typical funding strategy objectives:

- **Ensure access to capital and liquidity at all times:**
A strong credit rating provides access to capital and in particular diversified sources of funds.
- **Ensuring efficient cost of funds is achieved:**
Cognisance must be taken of the cost of capital for the corporate, the cost of swapping back into the home currency and the ability to opportunistically lock in attractive long-term interest rates.
- **Maintain financial discipline:**
The funding strategy must be developed taking into account guidelines to manage the financial strength and discipline of the corporate, and these can include:
 - **maintaining a target credit rating and financial ratios** (e.g. gearing, debt to EBITDA).
 - **stress testing the targeted financial ratios on a monthly basis** to ensure the balance sheet remains sufficiently strong to meet strategic objectives.

- most corporates will prioritise growth, and will only thereafter return excess cash (or balance sheet capacity) to shareholders via dividends and / or share buybacks ('allocation of capital' i.e. prioritising cash flows).
- 'live within means' parameters must be set to ensure that the corporate does not (on a continual basis), spend more cash than what it generates.

Achieve financial flexibility:

This is principally achieved by having access to diversified sources of funds, and maintaining debt capacity in order to enable the corporate to maintain and even accelerate growth (e.g. opportunistic M&A) through the cycle. `

Manage the financial risk associated with the funding:

Broad parameters within which the risk can be managed includes:

- Maintain access to diversified funding sources (by type and by location).
- Build strong relationships with providers of capital and ensure they understand the corporate strategy and how the funding strategy supports it.

- Refinancing risk must be managed within acceptable levels with excess cash flows and / or pre-funding.
- Maintain an adequate liquidity buffer to ensure unforeseen events or cash flow volatility can be managed.
- Project finance (if applicable) must have little or no recourse to the sponsors, and it should not adversely impact the corporate given the terms of its existing debt facilities (cross acceleration and structural subordination).

In conclusion, a funding strategy should be reviewed at least annually but more frequently if there is a significant change in the financial position of the Group.

Treasury should also educate senior management and the board on the key aspects of the funding strategy, as this will give them comfort and increase their support. Specifically, they must be shown that as long as the corporate maintains financial discipline and shows determination in protecting the credit rating, reliance can be placed on the funding strategy to support the corporate in pursuing its strategic objectives.

Riaan Bartlett, CTP, is a finance and treasury executive based in Pretoria, South-Africa



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At a LOSS

Questions arise over CECL's impact on transactions

JOHN HINTZE

New accounting for expected credit losses must be applied to calendar-year companies' first quarter financial statements. While mostly financial institutions have bandied about its potential impact, nonfinancial companies must also determine which transactions it will affect—whether as lenders or borrowers.

Real-world impact

The Financial Accounting Standards Board's (FASB) Current Expected Credit Losses (CECL) standard requires lenders to recognize credit losses expected over the life of a loan at the



“As people dive deeper and deeper, they’re realizing there are more balances in CECL’s scope than they would have thought”

outset. It replaces the incurred loss method that recognizes losses when they become probable.

Financial institutions have expressed concerns to FASB, the Securities and Exchange Commission (SEC), legislators, and all other relevant parties about the accounting change’s potential real-world impact, and they succeeded in requiring the federal government to study the issue. Some worry that during stressful financial periods, banks will have to ramp up their loan-loss reserves, eating into their capital and reducing lending when it is needed most.

Longer term, changes may be in store for loans and other banking products impacting corporate capital structures and funding. For example, to reduce the credit losses that CECL requires banks to recognize upfront, they may determine that riskier loans should have shorter maturities or other changes.

Michael Gullette, senior vice president, accounting and tax, at the American Bankers Association, said that changes to terms will not happen at once, but many banks are now discussing the issue. He noted that banks price loans across a term and length spectrum, so the market as a whole will determine the terms.

“We had a group of bank investors and analysts in and they said they were sure that repricing and changes in terms would occur, but it would probably take a whole economic cycle to be able to see the impact,” Gullette said. “If we get into an economic downturn, then you will see that happen quicker, I think.”

Part of the reason for the delay, said Tom Barbieri, a partner in PwC’s national professional services group, is that financial institutions are still seeking to understand CECL’s broader impact and the future volatility that could result. He noted that banks’ reasonable forecasts have tended to be over the next two to three years, varying by product. “If the economy were to slow down, at least in the short-term, that could lead to higher CECL loan-loss allowances,” he said.

Time to act

More immediately, nonfinancial companies must identify their financial assets that are subject to CECL. “As people dive deeper and deeper, they’re realizing there are more balances in CECL’s scope than they would have thought,” Barbieri said.

“Under the new accounting, the company creates an allowance that can go up and down. So there’s the ability to recoup losses.”

He noted that the transactions PwC has discussed most with clients have been trade receivables and net investments in direct sales and financing leases, in which the sale of a piece of equipment or other product is accounted for as a lease. Also under scope are transactions such as credit guarantees and employee receivables. Barbieri added that a separate impairment model that was proposed alongside CECL brings in available-for-sale debt securities.

Until the arrival of the new credit-loss models, companies typically relied on historical loss rates to determine credit allowances for transactions. With trade receivables, for example, they placed receivables of different ages in buckets—60-day, 90-day, etc.—and then looked at the historical loss rates relative to those buckets. But under CECL, they will also have to consider current and reasonably supportable forecasts. “So they’ll be thinking about what will happen in the future relative to those receivables, and not just those that are late,” Barbieri said.

He added that it will require much more judgment regarding how to view historical information and adjust it for current conditions and reasonably supportable forecasts. Trade and lease receivables, for example, will require companies to anticipate the state of the economy over the period they forecast, as well as the state of the company the receivable is from and the industry it is in.

“If the receivable is from a retailer, the company may want to think about the retail marketplace, where it stands, and the nature of the retailer,” Barbieri said, noting that the longer that period is, the more judgment will be necessary.

Implausible results?

CECL may also result in implausible results. For example, a nonfinancial corporate may provide a credit guarantee to nonconsolidated ventures or other joint-venture arrangements. Under previous generally accepted accounting principles (GAAP), the company would typically record a liability for the guarantee on day one.

“Under CECL, it will have not only that liability, the obligation to stand ready to perform under the guarantee, but it will also have to project out what it believes the credit loss could be over the life of the guarantee, as if it were a funded loan,” Barbieri said. “To record a loss on the same day you enter into that arrangement, on an arm’s length basis, is counterintuitive to ‘traditional’ treasury thinking.”

As part of the CECL project, the FASB also issued a new impairment model for debt securities that are accounted for as available-for-sale, one of three categories possible. Held-to-maturity securities are subject to CECL, and securities placed in the trading category are marked to market each period, and so already capturing credit changes in the income statement.

Today, GAAP requires companies to take a loss on an impaired available-for-sale debt security and write down the asset, but if its credit improves, the write down cannot be reversed. “Under the new accounting, the company creates an allowance that can go up and down. So there’s the ability to recoup losses,” Barbieri said.

Regulatory response

The issue of CECL impacting the terms of bank products raised enough concern to be included in recent legislation that was signed into law Dec. 20, 2019. The H.R. 15: Further Consolidated Appropriations Act notes concerns about CECL’s potentially adverse impact during “times of recession or economic crisis.” It directs the Treasury Department in consultation with the Federal Reserve and other federal banking regulators to conduct a study within 270 days of its enactment to determine whether any changes to regulatory capital requirements are necessary.

Gullette said the ABA is emphasizing that the study focus on how CECL could impact specific financial products and banks of different sizes. “So perhaps more consideration could be given toward capital factors based on product,” Gullette said.



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Executive DECISIONS

Finance is revising project analysis, but calculating the hurdle rate remains unchanged

Increasing volatility in product lifecycles is causing finance to shorten the time period analyzed for cash flows and demonstrate a preference for non-valuation metrics, according to the *2019 AFP Project Investment Decisions Survey*. The survey focuses on the process of project decision-making and how FP&A departments are savvy business partners that deploy corporate capital effectively.

Analyze less

Comparing data from 2019 with that of 2013, the survey revealed that 41% of respondents analyzed less than three years of project investment cash flows, an increase from 11% in 2013. Only 49% reported that they use terminal value (TV) as part of their

evaluation, a decrease from 82% in 2013, and 51% of all projects evaluated are 12 months or less in duration.

“The pace of change in the market is so fast—for companies and for products—that FP&A practitioners have changed their evaluation methods to adapt and be more responsive,” said Jim Kaitz, president and CEO of AFP.

Professor Aswath Damodaran of New York University’s Stern School of Business noted that these results make a lot of sense. “Projects don’t last forever,” he said. “In most of capital budgeting, unless you have a really, really long infrastructure project, I don’t see why terminal value would even come into the picture because there are finite cash flows. You can estimate the cash flows of that finite life and put

a salvage at the end and then you move on. If you're buying a going concern or valuing a company, terminal value is a more sensible construct, though you don't have to assume a perpetual growth rate that is positive. You can assume that your cash flow decreases 5% a year forever after year five, if that is what you see as the most likely scenario for your investment."

Tom Russell, FP&A, CPA, CFO of Fresh Products and a member of AFP's FP&A Advisory Council, added that the ability to forecast the future is becoming increasingly difficult as finance professionals' world is moving faster overall. "As a result of the shorter product lifecycles, reviewing projects on shorter time horizons is becoming more common," he said. "Additionally, as we continue to move to an information and knowledge-based economy, the terminal value of projects can often be zero. The project becomes outdated, obsolete, or doesn't have value to another organization. The decreasing use of TV puts more pressure on projects to deliver value quickly."

Cost of capital calculation

One area that did not change was the cost of capital calculation. According to Damodaran, finance departments have some catching up to do. Addressing the survey results about frequency of updates, he

observed, "There is a lot of consistency from 2013 to now, in terms of the calculation methodology and how it was applied, but consistency is not always a good thing because the world has shifted. You've got distrust of central banks, government and experts. You've got interest rates that are lower than the rates you have faced for close to a century. You've got macroeconomic shifts, and people are still doing what they used to do. The constructed cost of capital for a company should never be a constant for the whole year."

Damodaran recommended practitioners stay agile in re-valuing the project cash flows, the cost of capital, and especially the decisions after they are made. "All the numbers in your project analysis are changing," he said. "We live in a world of change. To think that change doesn't happen doesn't make it go away."

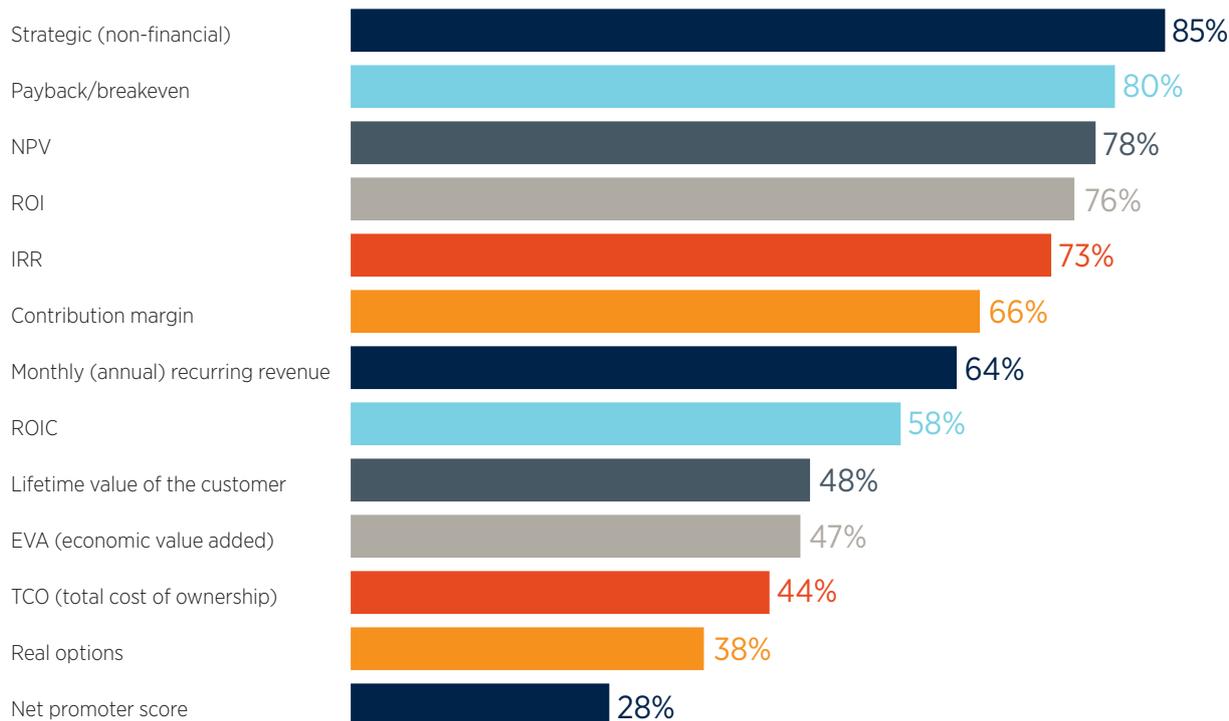
Common valuation metrics

Fully 60% of companies use five or more financial metrics to evaluate projects, and 27% use 10 or more. The most common financial valuation metrics were identified as strategic, (nonfinancial) cited by 85% of respondents, followed by payback/breakeven at 80% and net present value (NPV) at 78%.

The high usage of strategic can be seen either as forward-looking or dangerous. Russell argues for

Metrics Used in the Decision-Making Process

(Percentage of respondents that rated the importance 3, 4 or 5 on a 5-point scale)



Source: 2020 AFP Project Investment and Cost of Capital Survey Report

The Capex Group is more likely to use the following:
 (Percent of respondents)

	Percent of Respondents in the Capex Group	Percent of Respondents in the Opex Group
Financial metrics dominate, with marginal weight to non-financial	67%	50%
Higher use of almost all metrics, especially discounted cash flow		
NPV	63%	47%
IRR	55%	47%
Payback	55%	54%
More likely to model the balance sheet impact, answering “Usually”	52%	40%
More likely to conduct a post-project review, answering “Usually” or “Often (about half the time)”	78%	65%

Source: 2020 AFP Project Investment and Cost of Capital Survey Report

balance among metrics. “Without a good way to quantify the strategic value a potential project could bring, this has the potential of undermining the more quantitative tools available to review the project,” he said. “Between 73% and 80% of respondents used payback/breakeven, NPV, ROI and IRR metrics—the classic textbook tools to evaluate a project. These have not gone out of style and are a key part of the FP&A toolkit. FP&A and other finance practitioners are increasingly being asked to utilize ‘soft’ skills in addition to ‘hard’ skills. There is an opportunity to add value to take nonfinancial attributes and rank and prioritize them.”

The results signify the importance of quantifying strategic value in a project, though Damodaran expressed skepticism about the concept. “The word ‘strategic’ a weapon of mass distraction, which is basically when the numbers don’t fly, ‘strategic’ becomes the justification for overriding numbers,” he said. “I don’t have a problem if you use the word strategic to say, ‘Look, we think this is going to give us a chance to be in new businesses, to do something better.’ But you need to think through what the opportunities are, because strategic can become a substitute for the kind of analysis that should precede a big investment.”

Opex over Capex?

Finance professionals also revealed that FP&A is overall more involved in operating expense projects (Opex) than capital expense (Capex) ones. Survey results indicate that smaller companies (as measured by annual revenue) had a higher rate of Opex, but even the largest companies still had proportionately more Opex projects than Capex ones.

For this finding, the responses were split into two groups: 47% of respondents put themselves in the “Opex

group” that spends 75% or more of their time on Opex projects; 31% of respondents classified themselves in the “Capex group” that spends 75% or more of their time on Capex projects. Full 21% of respondents indicate they divided their time evenly between these types of analyses and they are not included in this comparison. Not surprisingly, the Opex group projects were smaller in terms of average dollar size and shorter in duration.

Truly agile?

Agile software development is an approach to creating and implementing software through business flexibility, responsiveness, and speed. Overall, 37 percent of respondents report that they adopted agile project development methodologies.

However, one of the most important tenets of agile was not supported by the data—that idea that projects might be terminated if they were not working or better options came along. According to Damodaran, agile requires the willingness to look at past decisions and reverse them, if the facts on the ground have changed. “This is a sunk cost problem these companies seem to have—once they’ve taken the product, they’re locked in and they cannot ever revisit that decision,” he said. “I think that’s a mistake. A part of being agile is being willing to say, ‘I was wrong’ and seeing if you can get some of your money back. It might be too late, but at least you can stop yourself from throwing good money after bad.”



The full survey results are available at:
www.AFPonline.org/research

MADLINE CANNON

Bridging the GAP

How Shell brought
finance and IT
closer together

Evangelism is not a phrase you hear often in the finance world.

But perhaps if your organization's connectivity went down and you were forced to come into the office on Friday at midnight—your child asleep in their car seat next to you—more of us would develop an impassioned perspective on improving work conditions.

And that is exactly what Michael High, FP&A and finance director for U.S. Gulf of Mexico Deep Water/Royal Dutch Shell, did. "This started my evangelism around: 'There has to be a different experience for our staff and for end users around how they engage with technology,'" he said.

Determined to find a solution to his team's frustrations, High went across the organization to Danny Meyer, IT director for Global Deep Water/Royal Dutch Shell. Together, they were able to bridge the gap between IT and finance, creating a "win-win-win" strategy that unlocked a value north of \$100 million and eliminated 94% of spreadsheets used in the forecasting process.

Begin where there is pain

On the finance end, High was keenly aware of the pain in Shell's current processes. A seemingly simple and logical business request required a myriad of spreadsheets, technical and non-technical data, etc. Compounding the pain was the separation of this information across different lines of the organization, each with different systems and data structures.

This led to a cascade effect. "Working a couple of layers up the organization in terms of our organizational hierarchy means asking colleagues in other places around the world for their questions, who then have to ask questions of the other stakeholders deeper in their business, who may even have to ask questions of others," he said. "A simple request results in 50 or 60 or 70 or 100 people necessarily being involved."

On the other side of this gap was IT, which had its own pain points. The past few FP&A projects had gone over budget due to over-customization, leading to continually late deliverables, and one fiasco where a multimillion-dollar project was axed the week it launched. While Meyer was focused on getting market standard solutions, and High was centered on making the finance

function more efficient, both were connected through a goal of making their respective processes easier. With that common ground established, they were then able to ascertain the business problem that they wanted to solve together, Meyer explained.

and embraced the concept of co-dependence. "The difference is letting go and letting others step up into a space and play their position on the pitch, versus trying to play their position and someone else's at the same time," High said. For them, collaboration represented the old

"The difference is letting go and letting others step up into a space and play their position on the pitch, versus trying to play their position and someone else's at the same time."

Win-win-win

It's no secret that finance and IT have a historically tense relationship. This in part due to the pervasive business bias that the gap between finance and IT cannot be brought together, each belonging to separate and enclosed silos that should not step on each other's toes. In reality, the gap between finance and IT constitutes a depth of positive partnership possibilities. In order to reach those possibilities, High and Meyer knew they needed to adopt a new organizational outlook and culture between their silos.

A crucial aspect to the Agile method is not only adopting the process, but also embracing the cultural mindset that will allow the method to succeed. In order to foster this change, High and Meyer ditched the concept of collaboration

concept of simply working across the organization. A co-dependence framework allowed them to shed the dichotomy of "finance team" and "IT team" and begin thinking about individual players and the multiple capabilities individuals could bring to this experiment as one unit.

One of the most important lessons High and Meyer learned from incorporating the fast-paced Agile method was that "air traffic controllers" need to be assigned early in the project to establish a center of excellence (COE). A project can topple over in the early phases if not appropriately scaled, which is a crucial element for a global enterprise like Shell.

With the team set, High and Meyer began their experiment. It was intentionally designed to impact less than 10 people but

incorporate highly confidential data. The experiment featured characteristics that would allow for future opportunities. “We felt it would give us enough to be able to work with to then be able to figure out what kind of changes in our behaviors, in our controls, and in our technology would we have to put in place to actually be able to get comfortable as a company with putting sensitive data in the cloud,” High said. “These were elements of that experiment that we injected into it to be able to have these proof points that then unlock much, much bigger opportunities thereafter.”

By creating room for malleability and future opportunities, High and Meyer were able to foster positive buy-in for their experiment. At the end of one of their four-week sprints, they had a minimum viable product (MVP) to present to the Upstream CFO. Despite the boldness of a raw deliverable, the positives outweighed the negatives; higher-ups were able to inject their perspective and feel part of the process. By bringing executives something unfinished, High and Meyer were able to open leadership’s eyes to what goes on in the trenches of the day-to-day work.

Involving senior leadership in this way was the third win in High and Meyer’s strategy. The first two were what IT and finance wanted independently, and the third was the business value generated for the organization. By incorporating multiple other opportunities to unlock later, they demonstrated that their experiment held an even greater organizational value outside of IT and finance. These possibilities encompassed numerous stakeholders needs, increasing executive buy-in and building a solid foundation of support.

"We have data at our fingertips instead of running reports that require so many people, who then come back to give you data that still may be faulty because it doesn't all fit together. We've solved those problems. We did our first user survey. We were at 93% positive feedback on a better user experience and better work/life balance. It was just an incredible success."

World-changing results

High and Meyer’s risky experiment paid off in over \$100 million in value brought to Shell. Since the completion, the two have their eyes set on expanding connected planning, as well as exploring how even more departments can work cross-functionally to generate more value. As far as evangelism goes, High succeeded in his efforts to positively shape the lives of his employees and those around them. One end-user of the project described the results as world-changing. “We are working much fewer hours,” she said. “We have data at our fingertips instead of running reports that require so many people, who then come back to give you data that still may be faulty because it doesn’t all fit together. We’ve solved those problems. We did our first user survey. We were at 93% positive feedback on a better user experience and better work/life balance. It was just an incredible success.”

Interestingly, as the experiment moved into its later phases, High and Meyer noted that their mishaps came from them drifting away from their core co-dependence mentality. “The root cause has been where we actually have lost sight of still playing this team sport and started playing it individually,” he said.

Perhaps that is the most illuminating lesson from High and Meyer—great success does not come from going it alone. Instead, great success happens when people decide the prerequisite of their success is the requirement for the development of advancement of others.

Don't miss Michael High's session at FinNext, The Power of a Diverse FP&A Team. Learn more at: finnext.afponline.org

Why Good Timing



MATTERS

Daniel Pink explains the importance of having perfect timing

STAFF WRITERS



New York Times Bestselling author and FinNext 2020 opening keynote Daniel Pink recently joined AFP President and CEO Jim Kaitz for an exclusive interview on the AFP Conversations podcast.

Pink, whose books on work, business and behavior have won multiple awards and have sold more than 3 million copies, shared his thoughts on how timing is truly a science that can help us make smarter decisions, enhance productivity, and boost the performance of our organizations.

The following are five key takeaways from the interview.

We tend to move through the day in three stages: a peak, a trough and a recovery.

“Our brain power changes over the course of a day. Sometimes it can change in pretty dramatic ways. The way to figure out the right time to do something depends on what it is you’re doing. About 80% of us have peak early, a trough in the middle of the day, early to midafternoon, and then recovery later in the day.”

The peak is the time to focus and tackle your toughest challenges.

“During our peak, that’s when we’re most vigilant. We’re able to bat away distractions. So during the peak, people perform better on what psychologists call analytic tasks—tasks that require focus and attention. So for, financial professionals, this would be something like going over the numbers, looking at an allocation or going carefully over strategy.”

The trough is when you should do more menial tasks.

“There’s an array of evidence showing that performance in nearly every realm of life drops sometimes significantly [in the trough]. So during that period don’t do stuff that requires a lot of brain power. Do administrative work, answering routine emails, etc.”

Make midpoints visible.

“In the NBA, being down by one at halftime is as advantageous as being ahead by two. And

so it’s a little bit of a paradox. How do midpoints affect us? One of the things that we see is that midpoints have a dual effect. Sometimes the fire is up, sometimes they bring us down. If something has a beginning and an end, it inherently has a midpoint. But we usually don’t see it. But in basketball the midpoint has a name; it’s half time and a horn goes off. And so one of the things you see in the research on motivation is that being slightly behind at the midpoint of something is extraordinarily motivating.

“There’s sort of like a two-step move in getting midpoints to fire us up. One of them is to identify a midpoint—make it visible. And the second is actually to say, ‘Hey, we’re at the midpoint but we’re a little bit behind.’”

Most of us take naps the wrong way.

“There’s a lot of research on napping and what it shows is that naps are actually really good for us—except that most of us are doing it wrong. A good nap is between 10 and 20 minutes long. Any longer and you start to develop sleep inertia, which is that groggy, boggy feeling you get when you nap too long. So I was a confirmed anti-napper and now that I’ve seen the evidence, I’ve actually turned around on that. But again, you want to have a nap between 10 and 20 minutes long, because if you nap more than that, there’s some downside to it.”



Don't miss Daniel Pink's keynote speech at FinNext 2020. Learn more at: finnext.afponline.org



NEW

MINDSET

It's time to embrace AI-enabled analytics to improve forecasting

ROBERT J. ZWERLING, LAWRENCE S. MAISEL, AND JESPER H. SORENSEN

We are entering a new era of digital finance that requires human and artificial intelligence (AI) to work hand-in-hand to achieve better analytical results for data-driven decisions. New software and cloud computing are making AI and advanced analytics available to FP&A without need of data scientists, extensive programming, and time-consuming resources. But is FP&A adopting these new tools at break-neck pace? Of course not. The adage “you can lead a horse to water but can’t make him drink” is sadly applicable to many FP&A experiments in advanced analytics that have proven successful—but all too often are not sustained.

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With the Mindset Model in view, we can readily begin to discern why too many successful analytics pilots are not adopted. Causes include the concepts of misalignment of Mindset, resistance to investment, and risk of failure.

Modes of failure

With the Mindset Model in view, we can readily begin to discern why too many successful analytics pilots are not adopted. Causes include the concepts of misalignment of Mindset, resistance to investment, and risk of failure. Misalignment is the most prevalent cause, and it is when business management and finance have different Mindsets, which will be explored in the case below.

Resistance to investment rejects the ROI from analytics and sees expenditures on tools and people skills for advancing to an Advisor or Strategist as a cost to be avoided vs. an investment. Risk of failure is when management is so worried about their personal path of advancement in the company that all things new, even when proven, are feared for risk of failure rather than an opportunity for success.

Misalignment

A finance group for a Fortune 500 telecom company conducted a test of unbiased statistical forecasting of product demand over a one-year horizon. It was highly successful, with an ROI over 200X, but the solution was not pursued because the finance team would not relinquish the role of a reporter—we call this “Death by Excel.”

When times are good, demand will consume most forecasts, and excess inventory is something to be avoided. But when times turn down—well, you know what hits the fan! The problem is biased product demand forecasts done in spreadsheets—as are done in most companies, even those with demand planning tools.

Biased means forecasts generated by humans, who while having excellent qualitative intuition of the business, are under personal and political persuasion toward a desired outcome. Case in point, have you ever seen a spreadsheet tell you something you didn’t want to see?

Unbiased forecasts are those generated by mathematics, which have no concern about what a CEO may want and are calculated from the input data.

Now, it’s certainly fair to argue that a human can determine what data is consumed by the mathematics and what mathematics are used, which can conspire to derive a desired outcome. This can happen when the tool is a spreadsheet. However, when implemented in modern AI-enabled analytics tools, these issues are mitigated and, remember, a primary purpose to use these tools is to avoid bias.

In the case at hand, a back test was done to learn if analytics would have predicted a downturn in demand that happened after the company had experienced 16 consecutive quarters of growth, and how far in advance the prediction would have been made compared to the internal forecast.

The results were dramatic. Analytics predicted the downturn nine months before the internal forecast and forecasted the demand 11 months in advance with some 98% accuracy vs. the internal forecast that was about 95% accurate. Had the company had the analytics back then *and* used it to make decisions, it would have been able to both adjust inventory and provide market guidance to mitigate impact on its profitability and resulting stock price.

The word “and” is emphasized because another deficiency in using analytics is, well, *using* analytics without human interpretation to make decisions. However, this is a story for another time.

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If you think this predictive intelligence was warmly embraced, you would be wrong. Instead, staff circled the wagons to berate and bury the test. But why? For the job security one thinks one gets from Excel. The only one who knows the data when a spreadsheet is used is the spreadsheet owner. The only one who knows how to operate the spreadsheet is the spreadsheet owner. And when the desired forecast does not match the actual outcome, the spreadsheet owner blames the data. The lack of transparency afforded by Excel translates to job security.

As the Mindset of the reporter is limited to Excel, this was the Mindset of the staff that sought to restrict the introduction of new technology. Management was out of touch with their data-driven imperatives. They paid lip service to analytics, but never pressed for it. Management’s Mindset of a strategist was confounded by their approach of NATO—No Action, Talk Only.

Existential threat

Lack of adoption of advanced analytics and AI is more than missing the boat, it’s an existential threat to FP&A for two reasons, namely, other groups will take it up, and a swath of people will leave for lack of job satisfaction.

The former is already happening, as groups like marketing are developing their own analytics in competitive intelligence, and company-wide functions are emerging, like the chief analytics officer. These developments will make FP&A analytics irrelevant and restrict the boundaries of finance to controls and compliance, transactional accounting, and historical financial reporting.

Job dissatisfaction is also in the wind. Next generation finance professionals are leaving college having learned and experienced analytics, AI and ML. These high IQ graduates see Excel not as a modern tool. Further, by any number of surveys, spreadsheets force FP&A to spend some two-thirds of its time in just managing data, formulas and reporting with no time available for high value analytics. It will become increasingly hard for finance to retain talented people if their day is consumed in low-IQ work of data preparation, reconciliations and report compilation of spreadsheets.

Young finance managers and directors are also drawn to advanced analytics. They see this and AI as a path to career advancement. Ignoring their desires will lead to defections to other departments and companies that can fulfill their career and personal goals.

Staying relevant

For FP&A to be relevant in 2020 and beyond, it will have to adopt advanced analytics and AI. The Mindset of the reporter was fine 20 years ago, but not today. If finance does not aspire to be at least an Advisor, it will not have a seat at the table. If it does not dedicate budget to new analytics tools and people skillsets, then its value to the business will be that of controls, compliance and historical reporting. Call it whatever you like—the modern CFO, next generation finance, or the analytics business partner—these are all about the future of engaging a culture of data driven decisions with AI-enabled analytics. So, what’s holding you up?

Robert J. Zwerling is managing director of Aurora Predictions, providing intuitive analytics with AI software for finance and operations. Lawrence S. Maisel is president of DecisionVu, a specialized management consulting practice focused on delivering measurable performance improvement through innovative tools and capabilities development that supports effective decision-making. Zwerling and Jesper H. Sorensen are co-founders of the Finance Analytics Institute, an organization that teaches finance how to implement an analytics culture of data-driven decisions.

For more insights, don’t miss the session, Using AI-Enabled Predictive Analytics for Unbiased Forecasting and Decision-Making at FinNext 2020. finnext.afponline.org



Polycymaking

How strong policies support best practices in treasury

ANDREW DEICHLER

A treasury department is only as good as the policies and procedures it has in place. Whether they are formal, specific policies or just general guidelines, treasury needs to have a cohesive framework to execute on key strategies. Policies may differ greatly depending on company size, structure, location, and industry, but they are undoubtedly a key resource for treasury.

A new Treasury in Practice Guide, underwritten by Kyriba, looks at how policies around cash management, payments and risk support best practices in treasury.

“You want to write your policies and guidelines to help protect the company and provide people with the basis of interpretation and how to handle situations—how to handle what to do and what not to do. Given that we're in an environment now where technology is rapidly changing, the perspective that I would take is that when you write a policy, if you go into the nth detail, it can open you up to new risk.”

The need for treasury policies

In 2004, AFP released the AFP Manual of Treasury Policies: Guidelines for Developing Effective Control, in response to requests from members for sample policies they could adopt for their organizations. In its research, AFP ultimately found that many organizations lacked formal written policies, or had not updated their policies in years.

Since that time, as the corporate treasury function has risen in prominence within most organizations, formal policies have become much more prevalent, and are updated more frequently. Indeed, with recent advancements in technology, as well as rapidly escalating threats like data breaches and payments fraud, it is imperative that treasury policies need to be kept current. However, treasury departments must also take into consideration that policies need to be broad enough so that updating is limited to only major needs.

“You want to write your policies and guidelines to help protect the company and provide people with the basis of interpretation and how to handle situations—how to handle what to do and what not to do,” said John Nielsen, treasurer for Henniges Automotive. “Given that we're in an environment now where technology is rapidly changing, the perspective that I would take is

that when you write a policy, if you go into the nth detail, it can open you up to new risk.”

Jennifer Dale, CTP, assistant treasurer for Sprint, noted that many companies of similar size to hers still don't have formal policies. But for perspective, having a policy is very helpful. “I don't think it's 100% necessary, but from a control perspective, it's nice to have that document to fall back on,” she said. “If anything, you have no gray area when you have a policy.”

Establishing and writing policies

Nielsen cautions against being too specific when creating policies because that can result in people looking for loopholes to work around certain standards. And again, with technology advancing, there could be big changes that are coming—though not necessary in all aspects of treasury. “For example, policies around payment systems are the types of policies that you should be looking at yearly,” he said. “But maybe you don't have to look so much at your cash management policy or an overall treasury policy so often. Still, you should be at least looking through it and making sure that there's nothing in there that needs to be updated.”

When crafting policies, one of the biggest challenges that treasury teams can face is trying to determine how much needs to be ironed out at the start. Many treasury organizations try to capture everything at the outset so that they don't have to frequently refresh their policies. The problem is that there's only so much you can predict about the future. “One of the hardest things that people have in writing policies is you think, ‘Well, okay, if I write this policy now, what happens when we get a better handle on Same Day ACH? Should I start to write some stuff in there now? No... I'm just going to wait another two months to do this until I find out a little more,’” Nielsen said.

All too often, however, that day never comes because treasury practitioners either get busy with other tasks or don't want to acknowledge that policies may need to change over time. “I think that is part of the problem; people get scared of just moving forward and putting a marker in the sand and saying, ‘You know what? I'm okay with having to update and refresh my policies,’” Nielsen said.

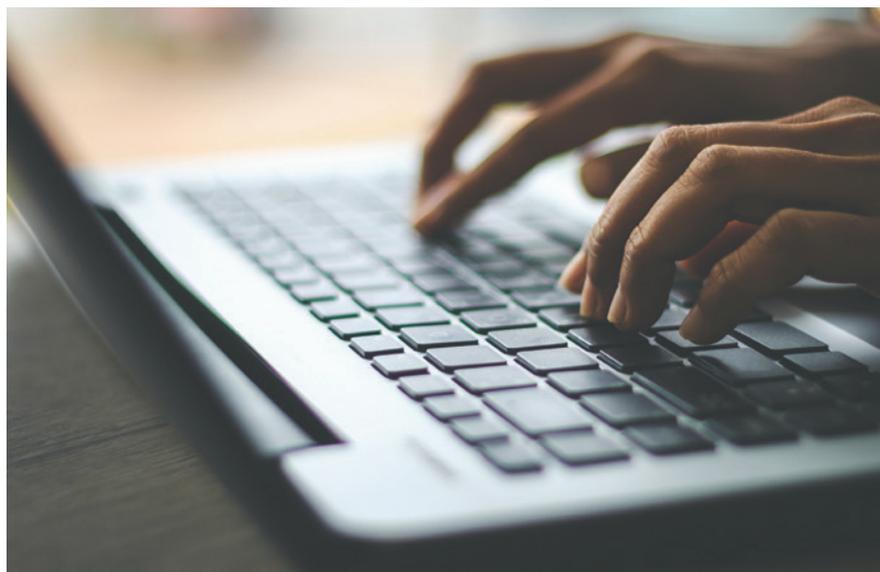
Establishing policies also depends largely on support from senior leadership and how the delegation of authority works within the organization. For example, at Henniges, both Nielsen and the corporate controller are responsible for a number of the policies, because they revolve around the controls of the organization. He noted that if both parties agree to a policy change, the CFO is highly likely to sign off on it. “If we get together and we’re fine with things, the CFO will perceive it as, ‘Go ahead; get it rewritten and put it out on our intranet. Send a message out to the people that need to know and say that we’ve got an updated policy, and here’s the section that has changed,’” he said.

In contrast, some treasury organizations must go to the board of directors every time they make policy changes. Needing that kind of constant approval can be quite onerous. “And really, your board of directors isn’t supposed to be your operational know-it-all,” Nielsen said. “They’re supposed to be strategic. Maybe it’s appropriate for certain treasury policies like foreign exchange or risk hedging, because then you’re dealing with the strategic direction of the company. But a lot of your other policies shouldn’t have to go all the way to the board for approval.”

Communicating policies

Communicating your policy to your staff can also be a challenge. Unless you are part of a large, multinational company, treasury is generally a skeleton crew, and it may be difficult to build out time to talk to your team members about your policies. “We’re a \$5 billion company, but I just literally have five people doing different things, including capital markets activity,” said Jim Gilligan, CTP, FP&A, assistant treasurer for Great Plains Energy, Inc. “So it’s a challenge to find time to sit down and talk with people.”

However, communicating these policies is a necessity when you bring new people on board, because you need them to understand how treasury does things, and why. “You can’t just bring somebody in and expect them to know everything in a relatively short period of time,” Gilligan added. “This is a complicated world that we live in, and understanding treasury’s role is overwhelming for a lot of people, especially if they get turned over in a position quickly.”



Cash management and payments

Policies around cash management and payments can differ from company to company, depending on the structure and size of the organization. According to the AFP Manual of Treasury Policies, a formal policy should communicate treasury’s objectives to the company and establish linkages between cash management practices and the company’s overall business management objectives. It should define the roles, responsibilities and cross-functional relationships of various departments involved in cash activities and promote consistent, uniform practices throughout the organization.

For cash collection specifically, relationships with other departments are especially important; it can be influenced by factors outside of traditional treasury. Input is often needed from sales and marketing, billing and accounts receivable. Treasury must have input into policies and practices that “touch” the cash collection and concentration process but are not actually under treasury’s control. The manual thus recommends appointing a “champion” to oversee the policy development process; this is typically the treasurer, assistant treasurer, cash manager or an appointed committee.

For Bob Whitaker, CTP, senior vice president of corporate finance for DHL and chairman of AFP’s Board of Directors, policies around cash management are fairly high level. DHL has operations in many countries, so its policies are mainly around which banks the company’s local operations should use. In most cases, they

should be working with global banks in DHL's bank group, as opposed to smaller local banks.

Treasury's role then is essentially governance over the company's operations in a whole host of countries, because it is not actually executing the local work, except the United States. Whitaker noted that cash management policies for those local operations can get pretty granular. "We require that they get our approval before opening a new bank account, and then they have to send us the bank account details," he said. "Then, you get into more of the procedural stuff, like, who can open bank accounts? Who decides who are signers on bank accounts? Who approves payments? That sort of thing."

When it comes to excess cash, many organizations use key performance indicators (KPIs) to measure the effectiveness of policies around the amount of total cash used for working capital. For example, the policy may be to use no more than 10%, and the KPI would reward treasury for getting below this number. Furthermore, a policy may specify what is an acceptable level of idle cash in accounts, perhaps distinguishing between remotely managed accounts by regional controllers, compared to operating accounts that treasury controls.

"We see many clients have policies around how to invest excess cash, with certain investment instruments or categories of instruments permitted," said Bob Stark, vice president of strategy for Kyriba. "Some industries, such as insurance, will also document how to invest operational cash differently than nonoperational cash, which can be provided to in-house investing teams to achieve a higher return on cash. A policy may state that treasury must have visibility and control of all corporate bank accounts, with approval rights on all openings and closings."

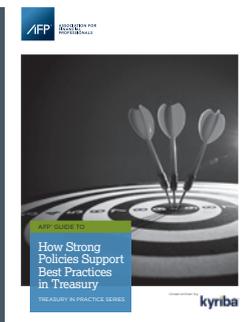
When it comes to payments, the goal of treasury policies are specifically focused on protecting against fraud. For a huge company like DHL, that means keeping a database of all its bank accounts around the world. "The goal is to prevent someone from stealing your money," Whitaker said. "So it's just really trying to put in all the controls you can."

As fraud threats have continued to escalate, CFOs and CIOs have begun to direct treasury to not only digitize payment policies, but also ensure their payment systems are set up to enforce those policies. Examples include real-time screening for duplicate payments, whether the right individuals have approved high dollar payments, or holding payments with modified delivery instructions for another level of validation.

DHL's guidelines include applying the four-eyes principle. This is essential with the epidemic of business email compromise (BEC) scams that has plagued treasury departments in recent years. Additionally, treasury at DHL doesn't allow anyone to direct debit its accounts, with a few notable exceptions. "Basically we try and secure our accounts, so we put debit blocks on them and positive pay," Whitaker said.

John Dourdis, CTP, vice president and treasurer for Conair, agreed about the importance of having strong policies, particularly around wire payments. "We make sure that we impress upon our colleagues that, you just can't take wire instructions over the phone," he said.

He added that these policies need to be cross-departmental so that everyone is in lockstep with one another. "Those particular departments should have their own policies and procedures, but we certainly support that," he said. "Safeguarding the company's money is obviously an important role."



For more insights and actual examples of treasury policies, download the Treasury in Practice Guide, How Strong Policies Support Best Practices in Treasury, www.AFPonline.org/publications

The New METRIC System

OpenText drills down to metrics at the operations level

JOHN HINTZE

OpenText has grown rapidly through acquisitions to become Canada's largest software company, collecting a long list of banks and financial software systems along the way. Several years ago, it began a treasury transformation initiative, aiming to make the department more efficient, cut costs and reduce risk—but just how effective has it been?

“Tracking the metric has allowed us to continue to focus on how we manage the balance and look for ways to reduce the exposures and costs.”

Micro metrics

OpenText has pursued an array of micro metrics that drill down past the standard financial ratios, such as working capital, interest coverage and other measurements that Wall Street focuses on, to those that measure operations. “We’re using the micro metrics to measure how those changes have benefitted the company, and whether we have made the key changes we need or intended to make,” said Jonathan Burkhead, senior director, global treasury at OpenText. “We’re using the micro metrics to measure how those changes have benefitted the company, and whether we have made the key changes we need or intended to make,” said Jonathan Burkhead, senior director, global treasury at OpenText.

For example, as part of its treasury transformation initiative, OpenText has dramatically reduced its number of its banks, approaching its target of 20 from over 150, and it has closed 425 bank accounts. It aims to maintain 150 bank accounts, although that number changes continually due to acquisitions.

To monitor progress and the resulting benefits, it has developed micro metrics such as tracking bank fees associated with those accounts. By removing fixed costs from banking

services, Burkhead said, treasury has found savings of more than \$1 million annually. And now that there are fewer banks to deal with, his group has been able to integrate them more completely, and thus automate more transactions with those banks than were previously processed manually.

In fact, reducing the number of banks was critical to the company’s successful implementation of SAP’s enterprise resource planning (ERP) software, since getting access to 120 banks and integrating them would have been an “impossible chore,” according to Burkhead. But integrating 20 is much more realistic, he noted.

Reducing the risk of fraud has been another major benefit. “Every bank account is a window of opportunity for fraud,” Burkhead said, adding that the more bank accounts there are, the more difficult it is for controllership staff to reconcile transactions, increasing the opportunity for fraud.

Creating such metrics has also helped treasury make decisions that have saved significant amounts of money. For example, it has tracked negative interest in primarily European accounts and determined that over the last year its balances there have grown to more than \$100 million in cash. “Tracking the metric has allowed

us to continue to focus on how we manage the balance and look for ways to reduce the exposures and costs,” Burkhead said.

Developing your own system

Smaller companies may have less need to develop micro metrics to measure aspects of their operations; a smaller domestic company, for example, may have only one or two banks, and thus face fewer cost and efficiency issues stemming from its bank relationships. Burkhead noted, however, that many midsize companies do significant business globally, such as one he worked for previously that had just \$200 million in revenue but upwards of 40 bank relationships.

Burkhead noted that metrics can be developed across the company, from operations to sales. The first step towards determining which ones to pursue, he said, is to identify the key activities that drive the business’s profitability. The next step is to drill down to the operational and productivity levels to measure factors such as efficiency and cost. For treasury metrics, that largely boils down to understanding the banking operations, which besides the number of banks and bank accounts includes the cost per transaction and the volumes of activities.

“Everyone knows ACH is the most cost-effective way to make or receive a payment. So how far am I from full utilization of that, and what do I need to get there, and how do I track that activity?” Burkhead said. “By tracking the volumes of ACH vs. wire and check, we can focus on those regions and accounts where we haven’t utilized ACH sufficiently.”

Ultimately, treasury should have little difficulty coming up with useful metrics to track, and it shouldn’t be difficult to decide the appropriate targets to reach. More difficult,

however, is obtaining the data to do that effectively.

Burkhead noted that a company typically has various systems parsing through transactions with its banks, such as a treasury management system (TMS) and an ERP, and depending on the transactions' syntax, they will be bucketed differently. Sometimes a BAI or SWIFT code is sufficient, or it may require a combination of indications to identify what kind of payment or receipt it is. In short, the method to arrive at the data is often unscientific and laborious, and potentially prone to errors, but it is the very data that goes into key metrics.

"You're always validating the data to make sure it's accurate," Burkhead said, adding that it is important for treasury executives to seek out other sources of the data that may be more accommodating and accurate.

For example, rather than treasury relying on internal systems to collect data about bank transactions, banks provide reports that may be more accurate. And for credit card performance, processing companies such as Paymentech, CyberSource and Stripe, provide analytical tools and reports.

Narrow your scope

One lesson learned, Burkhead said, is that it is easy to come up with a long list of metrics that could provide beneficial information, but it is also easy to go overboard. Somebody has to gather and analyze the data, so the need for those resources grows alongside the number of metrics, and taking on too many can result in watered down metrics that fail to provide useful information.

"Especially when you're getting started, just a handful or less than a dozen is probably best," Burkhead said. "Decide on which ones are priority, and what the ultimate objectives are and the key drivers to get there."

OpenText's Current Micro Metrics



Cash and Investments: Ending cash balances and excess cash, cash pooling, interest income and return on investment, minimum cash thresholds, and negative rates.



Currency: Trading volumes and currency pairs, trading in treasury and elsewhere.



Payments: Regions, types and volumes.



Credit Cards: Processing costs, dollar volumes, and days sales outstanding (DSO).



Bank Account Administration: Project progress, administration requests and bank reporting.



Bank Fees: By bank, region and entity.



Insurance: Claims, contract reviews, premiums and certificate requests.



More Metrics Under Consideration by OpenText:

- Bank costs per treasury employee
- Volume per treasury employee
- Dollars processed by treasury employee
- FX spreads
- Intercompany settlements
- FX offset during the quarter
- Hedging performance
- Cashflow forecasting accuracy
- Working capital and liquidity metrics



IRA KAWALLER

Swap Futures CONTRACTS

Democratizing interest rate
risk management solutions



Unfortunately, the typical transaction size in the swaps market is in the range of \$20 million, and entities with significantly smaller exposures may find few willing swap counterparties.

The world of derivatives provides financial managers with the wherewithal to address risks associated with volatility of interest rates, foreign exchange and basic commodity prices. But use of these tools has largely been restricted to large-scale institutions that typically transact in volumes of many millions of dollars. In fact, futures markets allow for the benefits of derivative tools to be accessible by a much broader audience. This article addresses interest rate exposures associated with existing variable-rate debt—i.e., the most common interest rate exposure problem for most business entities.

While a number of alternative tools might be used to address the risk of rising variable interest rates (e.g., Libor), the most typical solution would be to enter into an interest rate swap with an over-the-counter (OTC) swap dealer. The swap would effectively transform the variable-rate debt into synthetic fixed-rate debt, thereby obviating the preexisting risk. In the general case, a perfect hedge would set the notional size of the swap equal to the principal amount of the debt, where the swap's variable rate, rate-setting dates, and settlements were set equal to those of the exposure being hedged. With such a trade in place, the effective borrowing costs would end up being the swap's fixed rate, plus or minus any spread applied to the debt's variable resetting rate—i.e., synthetic fixed rate funding.

Unfortunately, the typical transaction size in the swaps market is in the range of \$20 million, and entities with significantly smaller exposures may find few willing swap counterparties. Moreover, those dealers who are willing would likely do so with wider bid/ask spreads than those provided to larger users.

Eris Swap Futures

Here's where futures markets come in. A relatively new swap future that was designed by Eris Innovations now trades at the CME Group—the Eris Swap Futures contract. These contracts should be expected to approximate the performance of their OTC swap alternatives, but the notional size of the Eris futures contracts, at \$100,000, serves to bring the benefits of the swaps market to a much broader audience.

Eris Swap Futures are available with tenors of two, three, four, five, seven, 10, 12, 15, 20, and 30 years. The listing month of the Eris contract indicates the start date of an associated interest rate swap, with contract expirations dictated by the tenor of the contract in question. For example, the March 2020 five-year Eris contract reflects a five-year swap with a start date of the third Wednesday of March 2020 and an end date (the contract expiration date) that's five years after the contract's swap start date (i.e., the same calendar day in March 2025). Thus, the listing month is not the expiration month. Instead, the expiration date is implied by the start date of the corresponding swap and the contract's tenor.

Critically, the buyer of the Eris futures is the implied receiver of fixed rates (payer of three-month Libor) and the seller is the implied payer of fixed rates (receiver of three-month Libor). Thus, the business entity facing the risk of rising interest rates would want to receive variable and pay fixed. Thus, this entity would want to sell the Eris Swap Futures contract. (Caution: This nomenclature is opposite of that used in the OTC marketplace.)

Eris Swap Futures have cash flow features that are distinctly different from that which would be realized with an OTC swap solution. Specifically, all futures—Eris included—require a daily cash settlement in lieu of the periodic settlements that would otherwise occur with OTC swaps. Here, the reader should understand a distinction between the traditional bilateral swap, where periodic settlements occur throughout the tenor of the swap, versus the swap that is registered with a central clearing facility that imposes cash flow requirements that mimic those of a futures contract. Albeit with some exceptions, cleared swaps are mandated by the Dodd-Frank Act for swaps transacted by financial institutions and major swap users, but nonfinancial hedgers are exempt from these requirements.

In any case, once buyers and sellers “meet” at the futures exchange and agree on a futures price, the contract is consummated and the futures’ clearing house becomes the counterparty for each of the original contract participants. The clearing process requires all open positions to be marked to market at the prescribed settlement time; and gains and losses must be settled daily, in cash. Losers pay and winners receive, with the exchange clearing house acting as the intermediary.

Besides assuring that winners get paid, this daily settlement process also forces the hedger to pay attention. Having to make cash payments signals that the risk inherent in the defined hedged item is not being realized, possibly suggesting that the hedge may deserve renewed consideration. This is not to say that losses on the hedging derivative should necessarily precipitate termination of the hedge. Rather, the decision to hedge simply deserves to be reevaluated. Ultimately, the determination to maintain the hedge should be based on a forward-looking assessment of the prospects of further adverse rate moves, as well as any changes in the hedging entity’s risk tolerances.

The daily settlement amount is called variation margin or variation settlement, and it serves to eliminate the risk of default, or credit risk. Further to that assurance, before a trade can be executed on the exchange, both of the original parties must put up collateral in an amount that is expected (in the eyes of the exchange) to cover the risk of a prospective price change over the coming day with a high degree of confidence. This starting collateral requirement is called initial margin or original margin.

While variation margin must be settled in cash, the initial margin can be satisfied with either cash or, more typically, some acceptable form of non-cash collateral, like Treasury securities. Ultimately, initial margin serves as a stopgap for the situation when variation margin requirements are not satisfied in a timely manner. But assuming they are, initial margin would ultimately be returned to the posting party after the futures position terminates.

The choice of the Eris futures (i.e., which of the contract listings to use) is dictated by the end date of the accrual periods being hedged. Appreciating that Eris futures have expirations at or around mid-month of their listing month, some mismatch of the exposure and the futures contract is inevitable. For instance, suppose, in early January 2020, the company decides to hedge its variable rate exposure of an existing variable rate debt that matures in February of 2023. Most likely, the hedger would sell the futures that expire most immediately after the exposure’s maturity date, but that contract would be liquidated coincidentally with the last reset on the variable rate debt being hedged.

Each Eris Swap Futures contract references an associated swap with a given fixed rate that’s determined on the day the contract is originally listed. That fixed interest rate will be close to the then-prevailing fixed rate of an at-market OTC swap covering the same start-date to end-date horizon. Although these fixed rates aren’t explicitly identified by the CME Group, they are available from Eris Innovations. While these fixed rates must be known in order to model the fair values of these contracts, if arbitrageurs are doing their jobs reasonably efficiently—as should be expected—these fixed rates are of little import to prospective hedgers. Of greater concern would be the timing mismatch between reset dates on the variable rate debt being hedged versus the futures’ variable reset dates.



Pros and cons

It's important to appreciate what hedging with Eris Swap Futures can do, and what it can't do. The promise of locking in a fixed rate is really something that won't happen without coincident (and equal) repricing of the two respective variable interest rates. Instead, using Eris Swap Futures transforms the exposure of the debt's variable interest rate to exposure to the spread between the two respective variable rates.

For hedges of variable rate liabilities, if the reset dates on debt precede the reset dates on the futures contract, and if interest rates trend upward throughout the hedge, the hedge will overperform (i.e., the variable component of the swap will more than offset the variable expense on the debt). On the other hand, if the futures contract resets first, the hedge will underperform (i.e., the variable component of the swap will more than less-than-fully offset the variable expense on the debt). The reverse would be true in periods when interest rates are generally falling. A more extended interim period between the resets likely allows for a larger difference in each accounting period, but the effect would only be systematic if interest rates trend in one direction throughout the hedge.

More generally, rather than transitioning to a known fixed interest rate, hedgers should expect the effective funding costs post-hedge to be "nearly fixed," varying within a relatively narrow band, with the variance depending on realized differences between the two respective reset rates. Showing this result in reported earnings on the income statement, however, is contingent on applying cash flow hedge accounting, which requires a one-time

effort to draft hedge documentation that includes articulation of quantitative effectiveness testing procedures that would address the sources of ineffectiveness inherent in the hedging relationship under consideration.

Despite the attributes of hedge accounting—notably that it makes the hedging objective and performance more transparent and understandable for the readers of financial statements—for many companies, hedge accounting may not be necessary. The standard, non-hedge derivatives accounting records all derivative results (i.e., the variation margin settlement amounts) in earnings on a current basis. This treatment may be perfectly acceptable. After all, hedge accounting is just bookkeeping. The same economics would be at work, irrespective of the accounting treatment applied. For companies that don't have to deal with the scrutiny of outside investors, and for those who (appropriately) have the requisite confidence that futures will perform as advertised, standard accounting may certainly be an appropriate choice.

Next best thing

Returning to the economics of hedging, for those companies that don't have the financial standing to participate in the OTC swap market, Eris Swap Futures provide the next best thing. While these contracts won't perfectly synthesize fixed rate debt, they offer a close approximation. In the world of interest rate management, something is generally better than nothing, and Eris Swap Futures can serve this purpose.

Ira Kawaller is founder and principal of Derivatives Litigation Services, LLC.



BEYOND LIBBOR

It's time for treasurers to begin thinking about alternative rates

ANDREW DEICHLER

With Libor expected to be phased out by the end of 2021, alternatives to the benchmark rate are emerging across the globe.

Mechanisms for establishing contractual fallbacks and adjustments to Libor-indexed financial instruments are being developed to minimize disruption, if in fact it does go away in 2022—though there are questions about whether that will truly happen. If Libor does end, however, the impacts on treasury will be significant.

During a recent AFP Conversations podcast interview, sponsored by Santander, we discussed the implications that Libor's end could have for financial professionals. Robert Owens, director of fixed income strategy for Farmer Mac, and Ruth Hardie, senior director of client services for Hedge Trackers, who both discussed this topic at AFP 2019, shared their insights.

Andrew Deichler: So you both generally believe that Libor is going to end after 2021. Robert, are you making preparations now? A lot of treasury professionals have been putting this off, but it sounds like you're being proactive.

Robert Owens: Yes. We are issuing SOFR bonds. We are entering into SOFR derivatives. We are actually exploring other IOSCO-compliant indexes like Ameribor and talking with our customers about SOFR and Ameribor.

Andrew Deichler: SOFR has been what everybody in the U.S. seems to think will be the alternative reference rate that that we'll be moving to. But there hasn't been as much discussion about Ameribor. So maybe you could talk a bit about what Ameribor is, and what treasury and finance professionals should know about it.

Robert Owens: Sure. Ameribor is a daily rate. It's IOSCO compliant, like SOFR. It's not really a competitor; it's more complimentary. It's basically unsecured bank credits transacting among each other. And it's about \$2 billion a day of volume and growing. It uses blockchain technology, so it can't be manipulated or anything like that. I find that really attractive. But the big thing is, there are over a 150 member banks and over 1,000 correspondent banks participating in transactions that are building this index. And the transactions are on the American Financial Exchange and it's very transparent. [Richard Sandor], who started Ameribor, also started Treasury futures. He's a very innovative thinker and it's a nice alternative. Obviously SOFR is a dominant alternative, but I think Ameribor has a nice place, especially in rural America.

Andrew Deichler: Interesting. So Ruth, for the treasury clients that you've spoken with, are you seeing interest in Ameribor? Are they aware of it? Or are they focused on SOFR? Or neither?

Ruth Hardie: We're definitely focused on SOFR because it's been approved as a benchmark rate by the [Financial Accounting Standards Board (FASB)]. In order for Ameribor to take off in the hedging world, it will have to become a benchmark. I understand that the FASB is looking at it

and considering it for a benchmark, but until that time, my clients tend to take their lead from what the regulators are doing. They're actively watching the FASB, and the FASB recently has come up with a new pronouncement of how to make the transition easier. So far we've seen nothing from Ameribor. It'll be interesting.

Andrew Deichler: Do you think the treasury and finance professionals understand that they need to start making a move? Because we've spoken to a lot of them, as well as other experts, and they have mostly said that they're just not taking action yet. They're just kind of waiting and seeing how this is going.

Ruth Hardie: I would say that's an accurate assessment. A lot of people are waiting, but I have some clients who have actually moved off of Libor already. They've gone exclusively into [overnight indexed swap (OIS)] as kind of an intermediate measure until SOFR is out there really actively trading on the swap market. But most of my clients at this point are taking a wait-and-see approach and we kind of recommend that for a typical corporate client that doesn't do a lot of trading. They don't want to be the first out there because the market is not liquid enough for them. They need to wait until the big guys are out there and they're playing in the field. But at the same time, we're warning people, you don't want to be on the tail end either because you may not have any leverage at that point. We're expecting that the market's going to be difficult for the next couple years—that it's going to be less transparent. There's going to be arbitrage opportunities. And ideally our clients will stay out of that to the extent that they can because they're hedging. That's what they're out there doing. They're not trading for profit.

Andrew Deichler: Before our interview, you had mentioned that Farmer Mac is one of your clients and they're kind of a market leader and they're going full on into SOFR. Do you both expect other corporates to follow your example as you make this transition?

Robert Owens: I believe it's binary. In general, large financial firms and [government sponsored enterprises (GSEs)] are actively trying to move away from Libor and build a SOFR market. But I think if you're not a large financial firm, you're just not involved in it yet. But I think you should be. I think anybody with Libor exposure needs to start assessing SOFR or Ameribor, or even look at OIS like fed funds OIS as an alternative. Just limit your Libor exposure as much as you can.

“I believe they should work beyond Libor. I'm on the ARRC floating rate note committee and fallback language is a lot more robust. But even [David Bowman, Senior Advisor of the Board of Governors of the Federal Reserve and a member of the ARRC] said that it's not infallible. It's a lot better, but it's not infallible. The quicker you're off of Libor, even with the robust fallback language, the better.”

Andrew Deichler: Sure. But for those companies that have Libor exposures, particularly in existing contracts, we've seen the SEC and the [Alternative Reference Rates Committee (ARRC)] talk about companies implementing fallback language to protect themselves. Do you think that that's a worthy effort? Or do you think they should just work to move beyond Libor?

Robert Owens: I believe they should work beyond Libor. I'm on the ARRC floating rate note committee and fallback language is a lot more robust. But even [David Bowman, Senior Advisor of the Board of Governors of the Federal Reserve and a member of the ARRC] said that it's not infallible. It's a lot better, but it's not infallible. The quicker you're off of Libor, even with the robust fallback language, the better.

Ruth Hardie: One of the things that corporates are dealing with though is, they've got existing contracts that go out 30 or 40 years—way into the future. As you had mentioned, the SEC has gotten on board and really dealt with probability first. And then the International Accounting Standards Board (IASB) has dealt with probability, and the FASB has an exposure draft out there dealing with probability. Because honestly without that right now, hedge accounting should stop because it's not probable. I don't think you can any longer say Libor's probable after 2021. It's possible, which gets into kind of the hedge accounting nuances, which are very important, but it's really not probable at this point.

The clients that we've had move off [from Libor] so far are financial institutions. On the corporate side, they have their derivatives to look out for. If they're in interest rate derivatives, they have a lot more than that that's going to be impacted by Libor going away. They need to be looking at all of their contracts, their transfer pricing, their intercompany loans—everything. And it's not just in the U.S., it's global that Libor is going to end. They are looking at it and they're starting to think about it. They're mostly just gathering information at this stage and waiting for the regulations to catch up.

Andrew Deichler: Well on that note too, since it is global, how is the U.S. doing, in comparison to other nations in its preparations to move off of Libor?

Ruth Hardie: I think we're doing pretty well. We're not at the forefront but we're close. I would say that Britain is leading the charge. Their reference rate is further along because it was an existing rate, whereas our reference rate, SOFR, is new. So we're going to have hedge accounting issues with SOFR in that, how do you test for effectiveness when you don't have historical rates? That's the big question that we're dealing with and talking to a lot of different auditors about what they will accept.

Andrew Deichler: You touched on some comments by David Bowman and I was at a forum at the U.S. Chamber of Commerce recently, when he spoke and he explained that many of the existing contracts, are poorly structured because people didn't think Libor could ever stop. And because these contracts didn't take an end for Libor into account, that it could be ultimately devastating to the financial system if the rate goes away. Do you see a catastrophic end for this?

Robert Owens: I do. If Libor honestly is going away at the end of 2021, there has to be some type of legislative solution to it, because you have the existing contracts that you can't change. This new robust fallback language is great, but it's for a dying index. So, something has to change.

Ruth Hardie: I guess I'm an optimist. I don't think there's going to be a cliff fall or anything like that. It's in the bank's best interest to protect their clients and I think they will do that. I think they will switch to SOFR. We have two years, which doesn't sound like very long and really, we haven't touched on it yet, but what corporates are waiting for is a term structure. We need a term structure and from what I'm reading, it's officially set to come out in late 2021. That's not soon enough. We need it before.

Listen to the full interview at: <https://www.afponline.org/ideas-inspiration/discussions/afp-conversations-podcast>. And be sure to visit AFP's Libor Transition Guide at: <https://dynamic.afponline.org/libor/>.

Necessary STEPS

Three elements of
a comprehensive
receivables
risk assessment

DAVID CULOTTA

With an ongoing trade war, the continuing Brexit saga and a potential downturn looming, uncertainty is the new normal. While conducting a comprehensive risk assessment of your receivables is always important, it is especially vital now, given the potential for rising payment default risk.

Simply put, receivables are the lifeblood of a company. If customers begin paying later and later or are suddenly unable to pay at all, your company's ability to fund operations could be threatened.

Simply put, receivables are the lifeblood of a company. If customers begin paying later and later or are suddenly unable to pay at all, your company's ability to fund operations could be threatened. A comprehensive receivables risk assessment is incomplete without three key elements.



1 A regular review of your receivables aging report

This task usually falls to credit managers. A receivables aging report aggregates unpaid customer invoices and unprocessed credit memos into buckets based on the number of days specific invoices have fallen beyond terms. It's a simple way of tracking overdue invoices and determining how well your credit and collection functions are working. Whether credit managers are looking over the aging report daily, weekly or monthly will depend upon the size of your company and its counterparties and the significance of the transactions at hand. Whatever the case, regular review is critical.

If your receivables aging report begins to reflect a material deterioration in trend, it may be time to investigate what's causing late payments before your customer's problems translate to a serious cash flow issue for your business. Maintaining regular contact with the buyer and tight credit controls will allow you to closely monitor such trends. In addition, it's important to understand the difference between industry-standard payment practices and early warning signs that your customer is experiencing financial stress. Focusing on deviations from typical payment patterns is key.



2 A regular credit analysis of trading partners

While the aging report provides a snapshot in time of customer payment behaviors, it won't necessarily reveal specifics as to the financial strength of your underlying counterparties. To gain this level of insight, you'll need to conduct fundamental credit analysis of your trading partners at least annually. The frequency of the analysis should increase relative to the credit risk profile of the customer with higher risk credits and more vulnerable buyers put on quarterly or semi-annual review cycles.

Include both bottom-up and top-down analyses. From a bottom-up perspective, key focus points include: Is the company generating cash? Is it profitable? Does it have sufficient liquidity to pay on time? Focus in on your customer's financial statements and banking information, paying particularly close

attention to how your customer is financing operations and working capital needs and the overall trend in total liquidity. Trade references and bank references can also provide meaningful insights into payment behavior and access to capital. Red flags and early warning signs include a heavy reliance on external financing, chronic poor payment practices, a deteriorating cash conversion cycle and an unexpected decline in total liquidity.

With regards to top-down analysis, take into consideration: What are the current macroeconomic trends impacting purchasing behavior within the industry? What are the current payment trends in the industry? What current external factors could materially impact the trajectory of the industry in the near future? What do analysts predict for the industry in the next six to 12 months? To answer these questions, you'll need to stay on top of industry news and analyst insights.



3 Initiating processes to manage deteriorating payment trends

If your customer typically pays on time but suddenly is paying two weeks late, what do you do? If you don't have detailed processes in place to manage deteriorating payment trends, customers are likely to take advantage of the "free" vendor financing. You should have systems established for quickly addressing and resolving late payments. Depending on the customer, your established history and the perceived level of payment default risk, you may

If your customer typically pays on time but suddenly is paying two weeks late, what do you do? If you don't have detailed processes in place to manage deteriorating payment trends, customers are likely to take advantage of the "free" vendor financing.

want to put a credit hold in place once the aging report has reached a certain threshold or have your internal collections team facilitate a call with the customer. If those steps don't solve the problem, have an escalation plan in place for written notices and legal action.

Your credit risk management approach should also include a defined process for evaluating requests for extended terms. The key is to separate out legitimate requests for extended terms related to seasonal working capital needs or one-off purchasing opportunities as opposed to an extension to avoid significant financial distress. Ask focused questions to get to the bottom of their request. If the customer is unable or unwilling to be forthcoming, that's probably a red flag.

Building in additional contact points with customers is recommended. Identify your high-risk customers and create personal contacts through an in-person visit. Personal interaction could lead to an increased understanding of the corporate strategy and future outlook and ultimately could drive increased credit support. The development of personal relationships will frequently lead to a greater comfort level with a customer's management team and their ability to effectively manage liabilities. This approach also gives you a chance to watch out for some of the softer signs of impending financial trouble, such as questionable management decisions, high turnover among senior management and problems with succession.

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REALISTIC EXPECTATIONS

How real are real-time
payments for corporates?

FARRAH PANJWANI, CTP, MBA, AND PETER J MACINTYRE, CTP



“Having real-time payments would be great to have for our business as it will allow us to have instant payments and detailed conversations with our clients and suppliers. However, it is a costly solution and decreases our working capital needs, particularly when we are pushing funds out to our vendors.”

The global payments community commonly refers to real-time payments as payments that are available 24/7/365, which settle and deliver available funds with confirmation to the payee in less than 60 seconds. While real-time has been around in Europe since 2014, there is now the emergence of real-time retail payments in North America, particularly with the advancement of smartphones. It is gradually creeping into the corporate world, as businesses look for alternatives to credit cards and checks.

There is immense work being undertaken by not only the governing bodies of the United States and Canada, but also by the financial institutions that will need to comply. The cost of such modernization will be measured in the billions.

Real-time payments may speed up the electronic value of the payments when compared to a traditional electronic funds transfer (EFT), in which the funds would need to be sent one business day prior to the value date. Search for “real-time payments” and you will be inundated by page after page of information mainly referring to low-value retail payments, however, there is and will be a continued push for corporates to follow suit for larger sums.

What corporates want

The question now is, is real-time needed by U.S. corporates? More importantly, is it wanted by corporates?

“Having real-time payments would be great to have for our business as it will allow us to have instant payments and detailed conversations with our clients and suppliers,” said Imran Gulam, CFO of FYidoctors. “However, it is a costly solution and decreases our working capital needs, particularly when we are pushing funds out to our vendors.”

To gauge the corporate need, we need first to look at the contributing factors that affect payments. Businesses of every size are driven by some type of cash conversion cycle, ideally one that speeds up receivables and delays payables as much as possible.



Wait, did we just say delay payables as much as possible?

Herein lies the first and possibly the most important challenge for corporates. Why would a corporate want to “speed up” payables? The answer is not that corporates want to speed up their payables—it is that they want to maximize their cash flow cycle, perhaps to delay it to the last second, using the most secure and least costly way to execute the payment, making “real-time” payments an option.

This allows for more efficient working capital to perhaps reduce debt, invest short-term, or make other purchasing decisions. What other opportunities are available for you to source additional funds or make use of funds with this additional liquidity?

How do you make better use of your money?

Say you have a payment with net 30 terms. You need to have it in the vendor’s hands by the 30th day. Some vendors will accept late payments without penalization, as long as it is dated by the 30th day. This creates check float value. The question is, when do you want the payment to physically clear your account?

One may ask that if they pay a real-time or near real-time payment on or before the 30th, what is in it for them? Is the vendor willing to accept an electronic payment, valued three days late, to account for check float?

Have a look at the following calculation. Say you have a \$1 million vendor payment this month, based on Canadian prime + 1 of 4.95%. Assuming a check float of three days, you are looking at a savings of around \$400 a month, which equates to \$4,800 a year. Now say you have 20 similar vendors. You are looking at nearly \$100,000 per year purely in interest cost savings by using checks as your payment method.

Perhaps you want to mitigate check fraud or create a more efficient payment process. Instead of checks, what if you paid electronically? You would look for increased trade terms. You can ask the vendor for a discount that matches the savings of a check float, or maybe you could add three additional days to the net terms.

“There is a fine balance to consider between savings from efficiency gains provided by real-time payments, and the impact on cash flow due to immediate execution of payments,” said Norbert Mazenod, CFO of The Lake Louise Ski Resort. “Efficiency gains are not limited to streamlined



Payments are complicated. While simple in concept, they can become difficult to manage and interpret. Corporate treasury professionals need to understand how they affect the business, company culture, and vendor relationships, as well as how they can maximize cash flows.

processes, and measurement should also include time savings from reduction of calls from vendors to our accounting or operational teams when looking for payment date information.”

One of many options

Today, real-time payments are just one of many different payment options for corporates. There is still plenty of work to be done, from processes for monitoring liquidity in the high-value payment system to operationalizing a new risk model and framework for the corporate system to safeguard all parties.

Payments are complicated. While simple in concept, they can become difficult to manage and interpret. Corporate treasury professionals need to understand how they affect the business, company culture, and vendor relationships, as well as how they can maximize cash flows.

The modernization of both business and retail payments is feeding a need for faster speed, greater flexibility and peace of mind. With the North American community developing a modern payments system that will provide new opportunities to simplify and enhance daily payment interactions, this will help secure and strengthen our competitive position as a global leader in financial services.

Farrah Panjwani, CTP, MBA, is senior director of ATB Financial. With nearly 10 years of consulting in the US, Farrah has provided financial analysis, strategic planning and expert testimony support on complex commercial disputes and over 5 years in the Treasury industry in Canada.

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AFP would like to recognize all of the newly designated CTPs from the 2019B (December 2019 – January 2020) testing window.

When working in treasury and finance, achieving the Certified Treasury Professional designation denotes credibility in your profession. These are professionals who have demonstrated the required knowledge, skills and abilities to meet this global standard of excellence.

The following financial professionals have successfully completed the rigorous examination requirements to earn their CTP designation. They should be congratulated for their achievement and praised for reaching this level of finance professionalism.

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THINK Before You Click

ANDREW DEICHLER

Looking over the data from the 2020 AFP Risk Survey, it came as no surprise that cyberrisk is top-of-mind for treasury and finance professionals. Indeed, I've written what feels like a million articles on cyberrisk over the past decade, as well as a few longform guides on the topic. I've interviewed practitioners, bankers, cybersecurity firms, and law enforcement, and all of them have said variations of the same thing—cyberattacks are only going to get worse.

When you immerse yourself in that world, you begin to recognize the telltale signs of common cyberattacks. You can spot a phishing email or an attempt at a business email compromise (BEC) scam a mile away. And so when you're following the headlines and you hear about how yet another huge corporation was breached—usually because someone fell for one of the oldest tricks in the book—you roll your eyes and say to yourself, “How do people keep falling for this stuff?”

And then you do it.

Yes, I'm sad to say that even I have gotten duped in an email when I should have known better. Fortunately, in my case, it wasn't a real phishing email, but a fake one sent by cybersecurity firm that AFP works with to make sure we're following cybersecurity protocols. I tend to think of myself as an expert (the jury's still out on that one) because I write about cyberrisk all the time, and yet here I was, facepalming at my desk because I didn't find an email that came from “AFP Human Resources” even a little suspicious. To be clear, any emails related to human resources issues at AFP come directly from the director of that department, not a general email account. So yes, I should have known better.

We're all human. We all make mistakes. But the wrong ones can be costly. So here I am, humbled by my own arrogance, imploring you to always be vigilant when it comes to your emails. Don't click on that link unless you are absolutely certain that it's okay to do so. In my case, it was a fake phishing email.

You might not be so lucky.



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