

# Auditing Treasury Activities

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# Overview of the Treasury Function

**Making sure the right amount of cash is in the right accounts on a daily basis**

- Day-to-day cash management is about ensuring that funds are available to meet business needs, not actually making payments to vendors and employees

**Working with senior management to set financial strategy related to capital structure and then executing that strategy**

- Managing to an optimal debt to total capital ratio
- Knowing the costs and benefits of an investment grade rating and managing communications with each of the rating agencies

**Managing interest rate, foreign currency and commodity risks**

- Assessing risks inherent in the business and determining how those risks should be mitigated

**Maintaining strong working relationships with a bank group and leveraging their expertise to execute financial objectives**

# Cash Management Activities

- Perform daily cash settlement activities
  - Monitor cash balances to ensure adequate access to liquidity
  - Monitor daily cash inflows and outflows and compare activity to forecasts
  - Review and approve all wire transfers
- Manage bank accounts
  - Centralized administration of all account maintenance activities
  - Maintain and monitor listing of accounts and related authorized signers
- Manage short term investments
  - Invest excess cash on a daily basis
  - Assess investment alternatives and recommend investment strategy

# Cash Management Related Risks

- *Risk* - Failure to effectively manage cash and investments can mean that a company is not able to meet demands on a timely basis
  - Employees arrive at work every day because they trust that a company will have the cash required to fund their paychecks
  - Vendors deliver tools and equipment needed to serve customers because they trust that companies will pay invoices when they are due
- *Risk Mitigation*
  - Establish a pre-defined target level for cash on hand
  - Forecast cash needs for both recurring and non-recurring activities
  - Ensure credit lines are maintained
- *Audit Approaches*
  - Determine whether senior leadership or the Board of Directors has defined target cash balances and confirm compliance
  - Review forecasts and assess whether the established target is adequate to cover typical daily activity
  - Ensure compliance with credit agreements and ensure that authority for accessing credit lines is delegated appropriately to ensure balance between safeguarding of assets and flexibility to manage the business

# Cash Management Related Risks

- *Risk* - Lack of proper safeguards to a company's cash can result in misappropriation of funds
  - Generally, Treasury is not the only part of an organization that needs access to a company's cash accounts
- *Risk Mitigation*
  - Segregation of duties is key
  - Limited number of authorized signers
  - Limitations to user rights (restrict non-Treasury personnel rights to deposits and report review)
  - Cash forecasting
  - Strong controls over operating disbursements
- *Audit Approaches*
  - Review established processes and controls looking for the following:
    - Adequate control over account set-up, vendor set-up and wire template processes
    - Non-recurring payments must be processed by one person, but released by another
  - Ensure forecasts are compiled at a detailed enough level to ensure that variances in particular disbursement categories are easily identifiable

# Cash Management Related Risks

- *Risk* - Accounting and reporting rules related to cash and investments can be complex; cash isn't always just cash
  - Fair value disclosures require that companies be able to separately identify, quantify and disclose cash, cash equivalents and investments
  - There are countless investment options for Treasury groups to choose from, and Treasury organizations may not be fully aware of the potential impacts of their investment selections on the company's financial statements
- *Risk Mitigation*
  - Regular communication between Treasury, Accounting and Reporting
  - Investment policies that limit Treasury's investment alternatives or require pre-approval of changes in investment strategy
- *Audit Approaches*
  - Confirm your company's various cash and investment balances
  - Ensure that Reporting teams are obtaining this documentation to support periodic disclosures
  - Inquire about your organization's investment processes, particularly considering:
    - Frequency of changes in investment approach
    - Authorization required before Treasury can pursue different investment alternatives

# Cash Forecasting

- Cash forecasts are a key tool for senior management in developing financial strategies, but they can also provide valuable information to a Treasury organization for ensuring that controls are operating effectively
  - Trends for operating inflows and outflows can be identified and used to assess actual results
    - Items like operating receipts, payroll, taxes and interest either follow distinct patterns or can be specifically forecast
    - Deviations from forecasted amounts can indicate a breakdown in process or operational issues that require attention
  - Forecasting significant non-operating cash flows, such as acquisitions, divestitures, dividends, share repurchases, debt borrowings and repayments, ensures that there is advance visibility to these transactions
    - These transactions generally require special approvals; by forecasting them, time should be available to get the right approvals and to ensure that all interested departments are given adequate notice
    - In addition, capital planning is often needed to ensure cash on hand will be sufficient to address the company's needs

# Debt Management Activities

- Coordinate issuance of debt in public markets
  - Requires collaboration between underwriters, internal and external counsel, accounting and external auditors
  - Not only subject to a company's own policies and procedures, but also subject to Securities & Exchange Commission regulations
- Ensure principal and interest are paid timely
- Monitor compliance with various covenants and coordinate all required reporting with trustees and facility administrative agent
- Forecast interest expense
- Monitor credit creation activities across the organization to ensure that activities outside of the scope of Treasury are considered when evaluating capital structure

# Debt Management Related Risks

- *Risk* - Incurring incremental indebtedness can have significant consequences to a company's financial position, liquidity and results of operations
  - Impacts to leverage ratios can be detrimental to a company's credit rating or compliance with credit and operating agreements
  - Incremental interest costs can be burdensome to an entity's operating cash
- *Risk Mitigation*
  - Authority for debt execution should be limited to only a few individuals
  - Significant borrowing decisions should require collaboration between company management and the Board of Directors
- *Audit Approaches*
  - Ensure that there are clear guidelines outlining authority to incur indebtedness
  - Confirm compliance with those guidelines
  - Ensure that covenant compliance is assessed on a timely basis post-issuance

# Debt Management Related Risks

- *Risk* - Capital markets can be volatile, which can result in uncertainty in a company's cost of and access to capital
- *Risk Mitigation*
  - Approach to debt issuances should be disciplined
  - Debt maturities should be balanced so that a company is not excessively exposed to the markets at any particular point in time
- *Audit Approaches*
  - This can represent a significant business risk, but it is difficult to address through audit
  - Value of audit function may be derived from ensuring that management is adequately reporting the nature and extent of the risk to the Board of Directors and/or risk committees

# Debt Management Related Risks

- *Risk* - Terms of debt arrangements can vary significantly; maturity and interest rate may not tell the full story
  - Balance sheet classification and related disclosures should be based on careful evaluation of the terms of debt arrangements
  - Special consideration can be required if your company has a holding/finance subsidiary that guarantees the issuer's debt obligations
- *Risk Mitigation*
  - Regular communication between Treasury, Accounting and Reporting
  - Review of relevant debt agreements in advance of execution by Legal and Accounting
- *Audit Approaches*
  - Review agreements looking for security requirements, terms that can make the debt payable on demand in advance of maturity, interest rate reset provisions, covenants and other restrictions, etc.

# Covenant Compliance

- Treasury is generally responsible for reporting that the company is in compliance with the covenants and restrictions of its credit agreements
  - Calculation of financial covenants requires a thorough understanding of both the company's operating results and the relevant debt agreement
    - Must determine how to align agreement terms with the Company's accounting records
    - Preparer should have thorough knowledge of the company's application of GAAP; financial covenants are usually tied to GAAP as of a specific reference date (i.e., December 31, 2010) so changes in accounting must be reconciled in completing the required calculations
  - All compliance monitoring may not be done by the Treasury organization
    - Subsidiary covenant compliance should be considered when cross-default provisions exist
    - Representations from subsidiaries should indicate compliance
    - Treasury should be informed of potential cross-default exposures to assess the significance of these risks

# Risk Management Activities

- Three broad categories of risk management activities are often incorporated into a Treasury organization's responsibilities
  - Interest rate
  - Foreign currency
  - Commodity
- Scope of work managed by the Treasury function can vary significantly, but the following are examples of key tasks:
  - Evaluation of risk and management recommendations for risk mitigation strategies
  - Negotiation of ISDA agreements
  - Counterparty credit risk considerations
  - Trade execution
  - Monitoring of trade values and effectiveness of risk mitigation strategy

# Derivative Transaction Related Risks

- *Risk* - Risk mitigation strategies often include complex derivative transactions that require careful evaluation for accounting and reporting purposes
  - Complexities must be addressed in advance of execution because if a derivative is not designated as a hedge at inception, there can be significant implications
  - Valuation techniques can vary significantly and, depending upon the size of a company's hedge portfolio, this can be considered an area with critical accounting estimates and assumptions
  - Disclosure requirements for derivative transactions are extensive and transactions must be well understood by both Treasury and Reporting to ensure that those requirements can be met
- *Risk Mitigation*
  - Regular communication between Treasury, Accounting and Reporting
  - Reliance on third-party valuation tools and valuations statements
  - Utilization of tools such as disclosure checklists derivative identifier tools
- *Audit Approaches*
  - Consider whether the organization has an adequate level of in-house expertise
  - Assess effectiveness of communication between Treasury, Accounting and Reporting

# Risk Management Challenges

- Derivative transactions are complex
  - Professionals in accounting, finance and banking develop careers that focus solely on understanding these transactions
  - Most organizations do not have the resources to have this in-house expertise
- Derivatives must be structured carefully to ensure that they are actually effective at mitigating the identified risk
  - This is an economic and accounting risk that should be carefully understood
- Integration of risk assessment with the remainder of the business
  - Centralized organization charged with identification and mitigation of exposures?
  - Does the part of the organization charged with executing a financial hedge strategy have adequate knowledge of related operational risks?
- Risk mitigation strategies are often reactive rather than proactive
  - Trends in Corporate America regarding counterparty credit risk
- Rules and regulations are constantly changing
  - The Dodd-Frank Act
  - Accounting and reporting updates

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