

# TREASURY

UPDATE

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## WORKING CAPITAL: For Fun & Profit – Part I

### Which Definition of Working Capital?

Do you want more working capital or less? The answer to that question often differs depending upon whether you are using the traditional or alternative measure of working capital. It is important to be clear which measure is being used. The accounting measure of working capital is quite straightforward:

### Current Assets – Current Liabilities = Working Capital

Using this model, having more working capital is often desirable. This measurement is still quite common and useful. This formula says nothing about the value to an organization of converting accounts receivable balances to cash. This formula wouldn't reflect any change as it is not designed to help an organization manage their key working capital categories. Lenders continue to use this as one measure of an organization's ability to meet current obligations.

The alternative measure of working capital is expressed as:  $A/R + Inventory - A/P =$  Net working capital

This measurement consolidates the cash conversion cycle balance sheet components. This formula is typically used by those that are responsible for improving the total organization costs of working capital. Not having adequate inventory or not offering competitive credit terms can reduce desirable sales. Many vendors are critical business partners and any adjustments must be made thoughtfully and in an appropriately communicated manner.

The accounts payable process also plays a role in the differing metrics that contribute to some unintended consequences.

• The Pizza Metric. When observing a pizza party at a company's accounts payable area a question was asked about whose birthday was being celebrated. It wasn't someone's birthday. A vendor provided this party each month if all of their invoices were paid before month end.

• It would not be hard to imagine that the vendor master record was modified to reflect faster payment requirement to ensure a smooth flow of pizza each month.

• Numerous examples of paying early exist where standard management reports are either not programmed, audited or even used to detect problems. "Invoices/Vendors Paid prior to terms" should create a highly visible flag. However, the terms are often adjusted on the vendor master or on the individual payment record eliminating the offending item from making the list. We will leave the "Taken/Missed Discount report" for another day.

Traditional measures of DSO, DPO and DI are excellent for examining and individual process area.

The alternative method, or looking at the entire cash conversion cycle, is useful for seeing the total cost of working capital and the opportunities and tradeoffs between components

- Craig Jeffery

*A detailed article on working capital by this author is scheduled for the 2nd issue of the Journal of Corporate Treasury Management in the fall of 2007. This is a subscription journal and more information can be found at [www.henrystewart.com](http://www.henrystewart.com). Strategic Treasurer friends receive a 10% discount by entering code "BS".*

Strategic Treasurer provides a wide range of advisory and implementation services for the financial professional. Our practice areas include:

### TREASURY MANAGEMENT

- Treasury Assessment
- Financial Process Reviews
- Process Efficiency and Controls

### WORKING CAPITAL MANAGEMENT

- Working Capital Optimization
- Order to Pay & Order to Collect

### TREASURY AUTOMATION

- Treasury Workstation (Client server, ASP)
- Risk Management
- Reconciliation
- Bank Account Administration

### RISK MANAGEMENT

- Risk Management Strategy
- FAS133 Assistance



# Top 10 Reasons Not to Hedge

The longer you're in the risk management business, the more excuses you hear of why companies do not hedge or consider managing their financial risks a priority. The reasons run the gamut, and unfortunately, typically all have a common theme – naivety regarding either risks or how to manage them. Moreover, the dark truth of the matter is that the majority of those that do manage their risks do not have a clear objective of how to measure the success or failure of what they are trying to accomplish. Too often the implied objective is ultimately speculation, i.e. time the market in executing one's hedge to capture the lowest cost possible for the exposure. Market timing is a difficult and often futile goal. If you've sat in the Treasurer's seat, or had a comparable role, and tried to convince your Sr. management of why your company needs to hedge and what you are trying to accomplish, then I'm sure you can relate.

In light of this, we recently conducted an informal poll among friends and associates in treasury, banking, and the like on the top-10 reasons organizations choose not to hedge. I use the word choose lightly as many finance managers, or their executive management, don't really make a choice as they may not even get that far in the process. The responses to my informal survey were both humorous and enlightening, and not too surprising.

In the spirit of Letterman, here are The Top-10 Reasons for NOT Hedging (least to most used excuses):

**10. Wall Street doesn't give us credit for hedging.** "There is no positive response from the street when you get it right because it's deemed not repeatable, while you get dinged when you get it wrong." True, our objective as managers is to create value for our shareholders, and Wall Street analysts are unfortunately a proxy for them, albeit a fickle one with a short-term horizon. Long-term value, as is well understood, is driven by the expected future cash flows of an organization's investments, which in turn are impacted by management's decisions and actions. Therefore, if risk management can impact any of these factors, then it can impact a firm's value. Hedging one's risks impacts investment decisions in two

primary ways: 1) mitigation of the likelihood of financial distress, and 2) predictability in expected cash flows. More importantly, it impacts the ability for management to plan by reducing the variability in the firm's cash flows due to extraneous events. As such, management is more confident in their ability to execute. Further, by reducing the probability of financial distress, or the likelihood that the firm's cash flows will not meet its requirements, the firm is less likely to under-invest, i.e. hoard cash or avoid raising capital for positive NPV investments. This is what determines value, and that is ultimately what Wall Street is concerned with. That notwithstanding, Wall Street, may not be your only concern. Other stakeholders, i.e. creditors, employees, Sr. Officers, etc., matter as well. More importantly, lack of an effective risk management process could impact your debt's rating these days.

**9. Risk is a cost of doing business.** True, but should it cost you your business? As they say, risk is in the eye of the beholder. It all depends on your perspective, and, more importantly, your risk philosophy, or your tolerance for risks. If you're in the oil business, pumping oil from the ground and ultimately into the gas tanks for example, then yes, risk is a cost of doing business for the most part as that is likely why you got into it in the first place. On the other hand (you have 5 different fingers – economist joke, sorry (S. Wright)), if you're a transportation company in a price sensitive market, and a heavy user of fuel, then your view of oil price risk is very different. Moreover, it is likely not the reason that you or your shareholders invest in your business. Therefore, it is a cost to be managed.

**8. Can't beat the market.** Likely true, at least over the long term. But, according to Keynes, "in the long run, we are all dead". The point is, your risk management objective shouldn't be simply to beat the market. That is a formidable task, and one at which you are sure to fail, or succeed, over time. Who knows? The important issue within risk management is to have a clear objective to measure the success or shortcomings of your hedging activity (failure is too harsh a word as this is not an exact science). One such objective may include, for example, pure predictability in relevant cash flows. While another acceptable one may be the mitigation of cash flow or earnings volatility within a specified range based on management's risk tolerance. Hedging is not about beating the market, however.

**7. Don't want earnings volatility due to hedging.** You may be missing the point here. Isn't earnings volatility, or something similar such as cash flow volatility, what one is typically attempting to mitigate by hedging in the first place? This excuse is likely driven by the unexpected impact to earnings of hedge ineffectiveness, which is dictated by the accounting rules per FAS Statement No. 133. Ineffectiveness, in general, occurs in a fair value hedge, for example, when the change in the fair value of one's hedged item (or change in cash flows of one's hedged item for a cash flow hedge) is not perfectly offset by the change in the fair value (or cash flows) of one's hedge instrument. The difference of which is carried through to earnings in the current period as opposed to deferred in an equity account, such as other comprehensive income (OCI). Depending on your hedge relationship, this could be minimal to severe, but the important issue is that this volatility is driven by accounting rules and does not likely impact cash flows. Therefore, the entity is forsaking the economics of an effective hedge for short-term, non-cash, accounting implications. There are other ways to fight this battle.

## Honorable mentions to the list of Reasons for Not Hedging:

- What risks?
- Hedging loses money.
- Investors can diversify away unsystematic risks.
- Making the wrong call could mean my job. - HW
- My credit card limit is greater than my company's credit facility. – AC
- We don't know who is in charge of hedging around here, would you like to speak to the receptionist again? – AC

**6. Don't know how to hedge.** And that is why the consulting business around risk management is thriving. You are not alone. Nevertheless, the head in the sand doesn't necessarily make for an effective risk management program, and, more importantly, wouldn't likely appease your stakeholders.

**5. Derivatives = Speculation.** Why does the d-word get so much bad press? Warren Buffet was once quoted as describing derivatives as 'weapons of mass destruction' (Risk. 2003). Derivatives, per se, are tools, which employed in the right situation by a knowledgeable financial manager, can be very effective in reducing risk. "The greatest risk that users of derivatives are subject to ... relates to management's investment actions and

decisions regarding derivatives” (J. Duchac). Speculation by definition is a pursuit of risk in the hope of profit from changes in the market price. ‘If we’re not managing our risks, then we’re speculating, no matter what the weapon of choice.’ (M. Miller)

**4. In the long run it doesn’t matter.** Yeah, markets are efficient, can’t beat the market, and we’re all dead anyway. Nevertheless, in the short run you may be out of business. While hedging can impact a firm’s value in several ways (see response to excuse No. 10), one of the primary influencers is in the reduction in the likelihood of financial distress. Consider the dilemma of the gambler’s ruin - wherein the gambler loses the last of his money and consequently is unable to continue gambling. The premise being: you may be right in the long term - have an advantage even - but with limited capital, you’re out of money in the short term due to adverse events. An effective hedging program should narrow the distribution of probable outcomes, i.e. risks, and therefore lower the probability of financial distress, all else being equal.

**3. One word: FAS133.** Ok, that’s not really a word, but apparently the fear of implementing FASB’s requirements for accounting for hedging activity is a popular reason to avoid hedging all together. Your reluctance here is understandable, but not acceptable; see response to excuse number 7. Moreover, there is a variety of options, including very effective software solutions, consultants, auditors, etc., to help with your accounting issues or burdens.

**2. Our risk management committee has not decided on a strategy yet.** Or, more likely than not, ‘we haven’t formed a risk committee’. I could write an entire article on why management by committee is not necessarily efficient, but that’s not the point here. A risk management committee is typically comprised of a cross-functional group of senior level managers. And, while it can have a number of objectives, its usual role with respect to purely financial risks, which lie within the Treasurer’s domain and management responsibilities, is to: 1) provide oversight relative to risk management activities and the entity’s risk policy, 2) provide information relating to exposures and the impact of risk management activities on cross-functional areas, and 3) ensure that the particular risk management activities are being carried out in light of the overall risk philosophy and objectives of the entity. It is more effective, however, when the Treasurer and/or the CFO combine to develop and ex-

ecute a strategy for financial risk management in line with the company’s overall philosophy and objectives, and let the Committee serve as both a sounding-board and an oversight authority, as opposed to developing and executing the decisions. Sorry, can’t avoid this excuse by getting rid of the risk management committee. Yes, you do need one.

**A**nd now, for the number one reason for not hedging (drum roll please Paul):

**1. We’re still looking at that.** Paralysis by analysis - the greatest pitfall in risk management is not managing your risks - inaction!

**R**isk management is complex. In light of this assumption, these excuses have stood the test of time. Effectively hedging one’s financial risk requires a deep understanding of your exposures, executive management’s risk philosophy, as well as clear objectives, policies and controls. Moreover, the decision of whether or not to hedge should be based on an objective cost / benefit analysis. What’s your excuse?

-David W. Stowe,  
CFA, Risk Management Consultant,  
Strategic Treasurer

## UPIC *An Account That Moves With You*

The Universal Payment Identification Code (UPIC) is extremely useful “account” for nearly all mid-sized and larger corporation’s receivables process. This “account” is currently available from most leading treasury management banks. This is a great tool that allows your customers to send in electronic payments the best manner possible. The UPIC is simple, portable and protected.

- **Simple.** Accept automated clearing house or electronic payments by providing and ABA/Account number combination.
- **Portable.** If necessary you can redirect your UPIC to another of your bank accounts if you so choose. You won’t even need to tell your customers to change anything.
- **Protected.** Publish your UPIC information without worrying about exposing your true bank account to fraud. The account cannot be debited by someone else. Money can only check in.

## Corporate Access Misperceptions

*Misperception #1: They are all the same*

**N**ot all methods of getting and sending information are equal, nor are all banks the same when it comes to providing and accepting information. However (and surprisingly) many corporations put the quality, availability and timeliness of critical bank data low on the list when deciding on global partners, treasury workstations vendors, etc. Bank systems that do not communicate well, transmit inadequate data in non-standard formats, have confusing methods of transmission, are poorly integrated, insufficient data warehousing, and improper planning for enterprise use will result in unsatisfactory visibility and inadequate usefulness. These issues can result in insufficient data that is not only hard to use, but a drag on the organization.

-Ric Thompson

The UPIC works essentially as follows:

- You are provided with a UPIC that is made up of an ABA-like number and an account number.
  - This information is mapped to a real bank account.
- When someone sends an ACH credit to your UPIC, the funds are forwarded on the same day to your target bank account.
- If you change bank accounts, you can redirect the same UPIC without having to notify your customers or asking them to change their payment destination.

It is definitely worth the time to ask your bank for information on how to get set up with your own UPIC - an account that moves with you.

- Craig Jeffery

## AFP Dinner Invite

Strategic Treasurer would like to invite you to dinner while attending the AFP Conference. We hope you will join us for an evening of fun and great networking. Dinners will be held Monday, October 22nd and Tuesday, October 23rd. Please RSVP by Friday, October 19th at: [csewell@strategictreasurer.com](mailto:csewell@strategictreasurer.com).

## Practice Area Developments

### Corporate Access and Connectivity.

We are expanding our capabilities for data connections and transaction management in 2007 and 2008. Our relationship with Camino Consulting and some of our plans will be made available shortly.

**Financial Risk Management.** Strategic Treasurer has continued to expand their risk management offerings. They now offer a specific set of outsourcing options for our clients related to FAS133 reporting and hedge economics.

## Conferences - 2007

- **SIBOS- Boston, MA**  
October 1-5, 2007
- **2007 Annual AFP Conference - Boston, MA**  
October 21- 24, 2007  
**Craig A. Jeffery & Robert Warren** (Diebold)  
- The Treasury Automation Landscape  
**Craig A. Jeffery & James Maxwell** (Hanesbrands, Inc.) - \$0-\$5B in 8 Months Flat: Creating a treasury out of nothing
- **Treasury & Risk Alexander Hamilton Summit – New York, NY**  
November 6-7, 2007

## Conferences - 2008

- **Treasury & Risk Conference – NY, NY**  
March 18-19, 2008  
Strategic Treasurer (Gold Sponsor)
- **TEXPO - Austin, TX**  
April 13-15, 2008
- **Windy City Summit, Chicago, IL**  
May 7-9, 2008
- **Payments 2008 - Las Vegas, NV**  
May 18-21, 2008
- **TMANE - Boston, MA**  
May 21 – 23, 2008
- **New York Cash Exchange – NY, NY**  
May 28-30, 2008

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## Treasury Videos on the Web

Our video viewer allows you to select the category of videos on the left and then jump over to the right side to look at a particular one. We have touched on a variety of topics in our videos from: Float, Positive Payment, Working Capital, Account Analysis, Remote Deposit Capture etc...

New videos arriving soon!  
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