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The implications of COVID-19 on Treasury Accounting

Finance and Treasury Management Switzerland

Alongside the undisputedly major operational challenges for corporate treasury, the particularities of how financial instruments are recognized in the balance sheet are now also becoming apparent for the reporting of 31 March 2020 at the latest. This also applies to interim reporting in accordance with IAS 34 and, of course, to annual or consolidated financial statements for financial years ending on 31 March 2020.

Below, we would like to address the key issues for corporate treasury and show how these were addressed in consulting and audit jobs handled by us.

Impact on hedging and hedge accounting

The global pandemic has led to the disruption of both manufacturing and supply chains in almost all industrialized countries due to the far-reaching restrictions on public life. This has had an immediate effect on the sales and market prices of goods and commodities. These, in turn, have often had an enormous indirect influence on the hedging activities of corporations, so that existing hedges, for example, have had to be rolled over or even liquidated.

Accordingly, the negative effects are now increasingly observable in the presentation of hedge accounting in the balance sheet. A number of factors are now even more important than before, especially when it comes to hedging foreign currency and price risks from planned transactions. The basic requirement of forecasting highly probable cash flows for the use of hedge accounting in accordance with IFRS 9 now seems more important than ever. Only if the previously planned incoming and outgoing payments remain highly likely even in the present pandemic scenario will it be possible to continue to use hedge accounting at all. Should cash flows become entirely improbable because previously planned sales cannot occur, e.g. due to a trading halt or production stops, the hedging relationship must be cancelled completely and the hedge results recognized in other provisions must be reclassified to current income through profit or loss.

In principle, it cannot be argued that a lower planned cash flow will be recovered in later periods. As a result, it is generally not allowed to roll forward a planning into the future by referring to subsequent catch-up effects even in a pandemic. Nevertheless, there are different cases and scenarios in which this seems possible to deviate from the general rule:

- In the case of distinctly identifiable individual transactions, such as in made-to-order production or customized orders, a postponement may be justified with reference to the specific ongoing planning. In this case, however, it must be substantiated in each individual case that the postponement is made for a reasonable period of time and is based on plausible assumptions. The postponement should also be

mentioned in the hedging transactions entered into for the transaction and must be taken into account accordingly in the hedge documentation[1].

- On the other hand, a delay is rarely possible in the case of goods that are sold in bulk. In this case, a postponement can only take place to a very limited extent and with reference to the COVID-19 pandemic as an unforeseeable event. The catch-up effect must occur within a reasonable period of time and must be substantiated sufficiently with plausible planning, which also considers the existing hedge ratios. The period and scope of the necessary evidence depend heavily on the industry, products and markets, so that it is difficult to define absolute guidelines. In any event, it must be ensured that the postponement does not conflict with already hedged future underlying transactions, resulting in a de facto over-collateralization in later periods. Another aspect to consider is that despite the impact of COVID-19, a continuous roll-forward of hedges may not be allowed, despite the hedging relationship generally providing for a roll-forward strategy. Rather, companies, and in particular Corporate Treasury, are expected to provide a reliable and crisis-adjusted planning. Although it is possible for companies to adjust their accounting hedges to the effects of COVID-19, there will be ineffectiveness from a shift in cash flows. Consequently, such ineffectiveness will have a direct impact on the profit or loss for the period in these cases as well.

Of course, there are also effects on balance sheet hedging relationships designated for recognized underlying transactions, such as receivables in foreign currency. Here, it is particularly important to what extent these hedging relationships are at risk of default, thus coming to an end prematurely.

Determining fair values and probabilities of default for financial assets

Corporate Treasury often acts as a center of expertise within the company for market data and fair value determination. COVID-19 causes two additional significant aspects of IFRS accounting that currently need to be considered in this regard.

The first is the determination of fair values under IFRS 13. The three-step concept ranges from directly observable market data (level 1) to derived market data (level 2) all the way to in-house model data (level 3). While the calculations in levels 1 and 2 may be subject to significant changes at the moment, such as those observed in the price of crude oil at the end of March / beginning of April, level 3 models will be subject to manual adjustments. In doing so, it is important to comply with the requirements of IFRS 13, since there may be no contradiction between these and the markets even the market data is unobservable. This can result in complex adjustments to forecasts and models for valuations as at the end of March. It should also be noted in this context that IFRS require a number of disclosures relating to forecast changes and sensitivities for level 3 models.

The second aspect pertains to calculating probabilities of default for valuation purposes. On the one hand, these are the credit/debit value adjustments required under IFRS 13, but under the new IFRS 9 impairment model, these now also include the probabilities of creditor default. Depending on the exact model used and the external and internal sources of the default probabilities, substantial adjustments may be necessary. The IFRS 9 impairment model requires, for example, that debtor-specific factors and macroeconomic conditions, including an assessment of current and future developments, be taken into account. If external data is sourced from third-party providers, Corporate Treasury must ensure that these comply with these requirements. But also internal data, such as historical default probabilities, must also take into account current developments .

[1] cf. IDW RS HFA 48 Tz. 346

Modifications and covenants in respect to COVID-19

Another relevant factor for corporate treasury at this point may be crisis-related modifications to the contractual terms of financial assets and liabilities.
In accordance with IFRS 9, financial assets that are contractually modified during their maturity must be assessed as to whether these modifications will lead to a derecognition in the balance sheet or only an adjustment. Depending on the qualitative and quantitative analysis of this issue, there may be implications for the profit or loss for the period.
For financial liabilities, it must also be assessed whether all covenants can be fulfilled in the current phase of the pandemic. If the contractual terms are adjusted in this context, it must also be reviewed whether the liability must be modified. A non-compliance with covenants may, however, also have other consequences for the reporting of financial liabilities. In particular, this could have repercussions on the allocation of non-current and current liabilities, which can ultimately have further consequences for key figures and the financing situation of companies.

It should be noted that an external report on COVID-19-induced changes is mandatory in the (interim) financial statements, so that the above-mentioned issues will arise at this point at the latest.

We are in daily contact with our clients but also with regulators regarding the effects of the current situation on corporate treasury. Needless to say that we will be happy to keep you informed about new developments regarding the effects on accounting.

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Treasury in crisis situations

Treasury stress tests

Finance and Treasury Management Switzerland

There will always be situations in which a company's viability is unexpectedly put to the test. Often the crucial question in such cases is not how well you react, but how well prepared you are.

The Corona crisis shows that critical situations are sometimes not handled with the necessary degree of seriousness. All of a sudden, many treasurers are starting to focus on liquidity transparency. While this may be all well and good, the question remains as to whether a different crisis situation might not also require a different kind of preparedness.

After all, the reasons for corporate crises are as diverse as the companies themselves. They range from a sudden plunge in sales, as we are experiencing during the Corona crisis, to an outright unexpected loss of human resources. Unforeseen events pose unique challenges for each company and treasury departments, and require stress-tested approaches to ensure that the company's going concern remains realistic.

Even in the event of a crisis, the treasury department should always be in a position to fulfill its core task of ensuring the company's solvency. However, experience has shown time and time again that companies will seek help only after things are already looking bleak.

We have summarized two such examples in anonymized form.

COVID-19 means a sudden downturn in sales (for many)

The unforeseen absence of a large part or even almost all sales (for an initially unspecified period of time) presents treasurers with an unprecedented task. The analysis of cash inflows and outflows must be fundamentally reconfigured.

On the revenue side, various scenarios have to be simulated, since the extent of the sales slump typically cannot be predicted with sufficient accuracy. These scenarios often range from "most likely" to "worst case". They must be combined with an assessment of the customer credit risk in order to determine the likelihood of payment resulting from a sale. Expected payments from products and services already sold but not yet paid for must also be taken into account. At first, such a situation may seem surreal, but it can occur as a result of major buyers being unexpectedly placed on embargo or sanctions lists, structural political changes or – as has happened just now – due to a pandemic. On the expenditure side, it is especially important for liquidity planning to take into account short-term operational measures. In this context, the treasury department must be assured that it is included in the comprehensive flow of information and data at an early stage.

Regardless of the reasons, liquidity planning that factors in the new situation is a core element for gaining an initial overview of the situation and being able to take the necessary

steps. In the current situation, we are seeing that treasurers who have long put off projects to create transparency on liquidity are now confronted with unpleasant questions from Management.

Conventional measures used to counter sudden slumps in revenue are:

- Securing new financing facilities
- Improving the cash pool with new limits and including or excluding individual companies from the cash pool
- Liquidating assets
- Making use of government loans or support programs

However, it is important to adhere to insolvency law for such far-reaching decisions as the inclusion or exclusion of individual companies from a common cash pool, so as to avoid personal liability of the parties involved. Being under time pressure often makes for mistakes with severe consequences. Therefore, it is essential that decision-makers understand their maneuvering room and the relevant constraints.

Treasury departments that have made the necessary provisions know which assets can be sold and also factor in tax effects in their evaluation. Companies holding shares in other companies, fund assets, art or treasury shares may liquidate these assets to improve the company's cash position in the short term. For this purpose, it is essential to document these actions, including the acquisition data and an approximate current value of these assets in order to best include the proceeds in liquidity planning on the one hand and to determine a fair disposal value on the other hand. Tax effects resulting from disposals must be identified and evaluated before the sale. Next to the measures mentioned above, government loans or support programs may also be a good way to ensure a company's liquidity.

What caught some Treasurers by surprise was that previously hedged exchange rates had to be adjusted and the resulting profits or losses had to be considered. From a hedge accounting perspective, if there is a foreseeable reduction in the underlying transaction, the hedging instruments concluded for this should be terminated; however, not only could such an action bring about price gains, but also significant losses. These must also be included in the liquidity planning in order to present a picture that is as close to reality as possible.

Another crisis could be the unexpected loss of human resources

Employees who become unexpectedly ill and therefore cannot work or important knowledge carriers who suddenly leave present many companies with unexpected challenges. It is unfortunately all too common that work steps are not properly documented and that a smooth functioning of a department is mostly due to the many years of routine an experienced team has built up over many years. If a person is suddenly absent, his or her colleagues will take over that person's tasks; this may still be possible in the case of two or three absent employees. However, if all of a sudden an entire department falls absent or is no longer with the company, this could become an existential threat to the company. Such a situation could be caused by different combinations of terminations, retirements, parental leaves, sick leaves or accidents, to mention just a few.

In the worst of all cases, a CFO might be faced not only with an unstaffed Treasury department but also with a complete loss of know-how. Because work processes and policies have never been properly documented, even experienced interim treasurers are often not a satisfactory transitional solution. Getting them up to speed would require marginally less time than just hiring new employees and starting from scratch. However, it should be noted that hiring new employees will also not solve the existing problem.

Because of a lack of documentation, policies and regulations, all processes and responsibilities have to be re-defined and documented. Generally, this means drawing up the following points:

- A clear description of the processes and responsibilities
- Adherence to the four-eyes principle
- Definition and update of the liquidity planning
- Securing of required financing
- Monitoring of existing hedges

Apart from a structured concept that clearly defines the responsibilities, the four-eyes principle must be ensured even in extreme situations. Such control is absolutely essential from a control point of view and also helps to avoid expensive errors, such as hedging in the opposite direction.

Not only is an up-to-date liquidity planning necessary but also the drawing up of the required (future) financing. After all, the company should be financially viable both today and in the future even in times that require a complete rebuilding of the treasury.

It is usually quick and easy to extract an overview of existing hedges (e.g. for foreign currencies, interest rates or commodities) from the Treasury Management System. In this particular area it is more a question of monitoring the hedges concluded, and, if necessary, to adjust these or conclude new ones. In this context, it is also important to continue to comply with the rules when forming valuation units or applying hedge accounting.

Although our two anonymized case studies may seem unrealistic at first glance, reality however shows that these things happen much more frequently than companies are prepared for. However, the measures mentioned only partially cover the necessary steps. The spectrum of necessary actions is so broad and individual that each company has to find its own way out of the crisis. Despite this, proper preparation for such a black swan events is often the decisive factor that will ensure the company's going concern.

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How to reduce your CO_2 footprint

Achieve a competitive advantage with Treasury Management

Finance and Treasury Management Switzerland

Transitioning to a low-carbon economy is generally considered to be the most effective way to curtail climate change. The political engagement backing this up was confirmed in the 2015 Paris Agreement, which foresees that global greenhouse gas emissions should drop to zero by the second half of this century. At this time, the Agreement's signatories are not obliged to reduce their emissions but have to re-port on these and explain the efforts made to reduce these. Such voluntary measures may lead to compliance with future legal provisions, especially if the signatories compare their actions and progress to those of their peers. As such, corporations that do not engage in lowering their carbon footprint may be-come subject to regulatory pressure to support the climate targets in countries where they are active. Moreover, it is becoming increasingly important for suppliers and distributors that their goods are used in climate-neutral production or have been produced in a carbon-neutral way. A good example are American retail chains that oblige their suppliers to use a significant proportion of electricity from renewable sources to manufacture the products marketed. Consumers have also become much more aware of their ecological footprint when shopping.

We are still at an early stage of this transition and it is still unclear where this journey will eventually lead us. What is clear, however, is that apart from actual energy corporations it is also energy-intensive industries that will play a leading role in significantly reducing emissions with their energy efficiency programs or by using renewables. Even without knowing the exact timetable of the global energy revolution, companies with an energy strategy will find themselves better prepared to adapt to new requirements regarding climate neutrality and the possibility of using alternative energies.

Corporations spend millions every year on energy alone. Companies that are not in an energy-intensive sector consider energy procurement more as an administrative cost rather than a strategic part of their value chain. Corporations that do not have a decarbonization strategy risk losing the trust of stakeholders, market shares, community support, investment opportunities and staff loyalty, thus jeopardizing the company's survival. Even an insufficient consideration of the ESG strategy driven by the EU may lead to reduced corporate financing possibilities (see our Treasury Newsletter 88 from February 2019). Energy, which was previously measured solely as a cost, is now becoming a key driver of business success. If Procurement and Treasury Management cooperate in this area, this can lead to considerable success. Often, this happens with the conclusion of strategic PPAs or the so-called "greening" of purchased electricity. This describes the process in which a corporation voluntarily purchases CO2 certificates in order to fully or partially compensate the exhausts it emits when using gray or brown energy in production. In doing so, Treasury Management coordinates the definition of future needs (exposure) and then acts in a leading role when executing the corresponding strategy on the market.

It is also becoming increasingly clear that decarbonization strategies must be designed for the long-term even if the macro-economic environment surrounding decarbonization is

rapidly changing. Using an appropriate strategy may lower the price and volume risks for energy procurement, and also makes for a certain independence from the volatile energy price effects of fossil fuels. Unpredictable energy prices may have an impact on energy costs and costs for liquid or gas-like fuels. A decarbonization also reduces a corporation's exposure to potential CO2 emission charges. Corporations with a long-term strategy are much more resilient in times of crises. This means not only considering risks but also taking ad-vantage of any emerging short-term opportunities and incentives for companies to drive change. After all, decarbonization and sustainability measures can open up profitable channels. Being an early user of low-carbon energy can result in competitive advantages. For instance, corporations with a certain sustainability accreditation (such as the CO2 Performance Ladder in The Netherlands) may receive preferential treatment when tendering for projects. The development of alternative solutions and the reduction of CO2 emissions will allow a corporation to outbid its competitors by securing a (short-term and) long-term cost advantage.

Improving the CO2 footprint

Corporations have several possibilities to reduce their CO2 footprint, from implementing energy efficiency programs to developing their own renewable energy production.

The intention of energy efficiency programs is to reduce a corporation's CO2 emissions due to lower energy consumption or fewer emissions per energy unit. Such projects may be manifold and, depending on their design, can also take place without Treasury Management's participation. For instance, it could mean a more economical use of fuels or a more efficient use of materials in order to bring about a reduction of CO2.

What is more complex, also in its implementation, is the acquisition and management of certificates or proof of origin with the intent of compensating CO2. Such projects require the treasurer's expertise be-cause these certificates are highly complex financial instruments.

A currently favored means to improve the CO2 footprint is the procurement of renewable energy with Power Purchase Agreements (PPAs)[1]. Generally, two main types may be found in the market. In a physical PPA, the producer feeds into the same pricing zone as the one where the counterparty draws its power. This means that there is a direct and physical delivery which is also relevant to the accounting grid. There are on-site PPAs (where the producer and the supplier are physically near) and off-site PPAs where energy is delivered through the public grid. The second type of PPA is called synthetic or virtual because it brings together energy producers and users from different pricing zones. PPAs not only define the regular parameters such as volume, delivery times and pricing, but also mutual codes of conduct, maintenance duties and termination clauses. Several factors make the valuation of PPAs a challenge for the contractual parties. Typical risks and questions to be answered concern counterparty risk, volume risk, foreign currency risk, the integration into already existing software environments as well as the map-ping in the balance sheet – thus touching upon Treasury's main areas of expertise.

Another possible element of a company's decarbonization strategy could be to produce its own energy or manage renewable power systems. However, for this, you need profound knowledge on energy management as it requires relevant processes and structures that need to be in place or implemented.

Challenges encountered in procuring renewable energy

Procuring renewable energy is a complex business as it requires the management of numerous risk pro-files because business activities may cover various regions and markets.

[1] Edition 95 included the following article: Purchasing Power Becomes a Treasury Topic – Risk Management for Power Purchase Agreements

Achieving the goals in regard to renewable energies requires much experience and extensive know-how within the corporation.
As there are many different technologies and contractual options to achieve decarbonization, the decision makers have to be in a position to evaluate the complicated selection criteria. Thought should also be given to an adequate financing or financing possibilities that will allow the corporation to reach its goals. Globally active corporations will have the additional onus of having to make investments in different companies, in consideration of local prices, taxes, subsidies and/or financial incentives. When planning their strategy, decision-makers will also have to consider how to handle lacking local infrastructure or their commitment at country level.

Strategic considerations

Essentially, corporations will have to think about strategic considerations necessary for success and they have to ensure the right combination of expertise across functions in order to develop the most adequate solutions.

Implementing a decarbonization strategy requires an integrated and step-by-step approach, which may be broken down into four steps.

1. Assessment of corporate goals
Corporations need to clearly define and assess short-term and long-term goals that should be based on the most important measures to be taken, drivers for decision-making and corporate limitations. Be sure to think of aspects relating to strategy, financing and taxation as well as social and ecological acceptance already in this phase.

2. Development of options and strategies
Once the corporate goals have been defined, it is a good idea to group options on how to assess and make decisions, and which projects belong in short-term/long-term procurement strategies. Developing a robust and dynamic financing model serves to improve assessments and predictability of the implementation by validating all options and listing the results at various levels of consolidation. Furthermore, an assessment of the financial structures should be performed for each jurisdiction (i.e. regarding equity, debt, climate bonds, etc.) that takes into account financial structures, partnerships and contractual strategies (PPAs, certificates).

From a Capex/Opex perspective, the technical options and the critical review of the overall deployment of technologies are as important as identifying technology risks and assessing performance under local conditions. Decisions must be taken on the type of technology to be used (wind, sun, water, biomass, geothermal) and the type of installation (off-site/on-site) and regulatory limitations must be taken into account. Moreover, market conditions (procurement options, pricing, taxes and incentives, readiness and social acceptance) have to be evaluated in order to define market introduction strategies and program governance.

3. Evaluation and roadmap
The goals defined in the decarbonization strategy have to be evaluated for their feasibility and market introduction strategies, as well as their impact on decision makers. Developing a short-term and a long-term roadmap supports the implementation based on local knowledge as well as financial and operational criteria. The program and the governance model should identify procurement possibilities and scenarios as well as local solutions (e.g. availability of PPAs and market suppliers). An implementation roadmap serves as the base for managing the program's implementation.

4. Implementation

Thinking about and implementing a decarbonization strategy is complex and requires the involvement and knowledge of many divisions. Treasury is especially involved in the settlement (i.e. financing and liquidity planning) and in risk management (such as for foreign currencies and interest rate hedging). The issues range from the development and implementation of the strategy to the evaluation and capture of financial instruments (certificates, PPAs, etc.) in the operating business.

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Counterparty credit risk mitigation

What short-term influence can Treasury have?

Finance and Treasury Management Switzerland

The true value of liquidity becomes particularly obvious in times of crisis. This has been the case in the past few weeks during which many companies were forced to reduce or even close down their business activities in view of the widespread shelter-at-home rules implemented to stop the rapid spread of the Sars-Cov-2 virus. A situation that combines shrinking revenue with overheads that remain constant can only be mastered with well-endowed liquidity reserves, unless the company makes use of governmental support and assistance. The main condition for such a bridging fund however is the stability and the reliability of the liquidity reserves that had been built up before. For seriously non-performing companies, the question of the stability of one's liquidity reserves may seem like a luxury problem. However, for companies with significant cash that they have built up as a precaution, this may well be a serious cause for concern, because all of a sudden, their banks' credit rating has become a decisive factor. For CFOs and treasurers, it is becoming more important than ever before that their financial business partners are not the proverbial black boxes as far as their financial reliability is concerned but that their credit rating is clearly identifiable and quantifiable, thus providing a good basis for decisions regarding the company's business partner policy. These then are the core topics that keep the specialized finance function "counterparty credit risk mitigation" up at night.

The basic tenets of counterparty credit risk mitigation (CRM)

Counterparty credit risk mitigation can basically be broken down into four areas, as shown below:

- Organization and employees
- Policies, processes and documentation
- Credit risk management methods
- IT landscapes and reporting

Structure and organization in CRM

We should begin by understanding what position counterparty credit risk mitigation has within the finance department and to establish an independent structure. In a first step, the organization should cultivate the relevant skills, the required expertise and provide the necessary time to define the first steps towards a long-term CRM, implement these in projects and allow them to flow into daily work. It is often a clear advantage to have a strong and centralized area of responsibility for the company-wide banking policy instead of a decentralized approach (taking into consideration the size of the company and the diversity of its global business strategy). A further organizational aspect of importance are the regular meetings where a committee made up of senior treasury staff can exchange ideas on policies, KPIs, changing market conditions and related topics, and then make relevant decisions.

How to implement the risk strategy in the CRM

Based on the strategy defined, the company should establish policies and processes for the counterparty risk management. A clear and comprehensive documentation is required in order for processes, activities or systems to retain a consistently high quality. When documenting, it is important to think of both document types, i.e. i) policies and ii) work instructions. Combining policies with working instructions eventually results in a target process that may be questioned, confirmed or critiqued during the target/actual process analysis. This is why the following three aspects are of such utmost importance: i) that process, task and system descriptions even exist, ii) that everyone involved has read and understood the documentation and iii) that there are regular reviews of the structures and workflows where these are scrutinized and reconfirmed. Ideally, this happens with the establishment of such control routines within an independent internal control system, which then oversees the previously defined credit risk management methods. For instance, a very basic aspect of a good banking policy is to avoid being too dependent on a single business partner. A well-thought out core bank strategy that has been equipped with a functioning system of limits can guarantee this. A prerequisite for this is a good grasp on the key performance indicators (KPIs) used to assess individual and portfolio risks.
As already mentioned above, managing business partner risks always follows the same four-step risk cycle:

i) Risk identification
ii) Risk measurement
iii) Risk management
iv) Reporting

This four-step risk management cycle should be reflected in the overarching risk management model. The risk management model itself should be based on an active model life-cycle management and a process review cycle, thus guaranteeing the continuous significance and accuracy of the results of the model and the processes.

The procedures and processes depend heavily on the IT environment at hand. Most treasury departments do not have an unlimited IT budget in order to be able to live a "system follows process" approach. Instead, it is usually "process follows system", where the system performance possibilities have to be taken into consideration when defining structures and workflows. Purely from a risk management approach, there are two IT and reporting criteria that are absolutely relevant; i) group-wide standardization of data management and ii) a reliable early warning system for credit ratings.

Protection of deposits and investor compensation

All of the measures mentioned above also intend to safeguard a company's deposits. Especially in the current situation with a possible economic slump in the offing and a potential increase in company and bank defaults, the protection of deposits is becoming a more pressing topic to treasurers, which is why we would like to provide a brief overview.

Basically, all cash deposits of private clients, partnerships and large corporations are subject to the Deposit Guarantee Act. This applies to account balances, including fixed-term deposits and savings deposits, as well as customer receivables from securities transactions.

The Investor Compensation Act protects commitments arising from securities transactions of private investors and small businesses. A complete list of investors excluded from protection may be found in §3(2) of the Investor Compensation Act. Claims against the bank for the surrender of securities held in custody are also protected.

In addition to the statutory security systems, there are also private compensation schemes, for example if the bank is part of the liability network of the Sparkassen-Finanzgruppe or the Federal Association of Volks- and Raiffeisenbanken. Treasury should be aware if their house bank belongs to any of these private compensation schemes and to what degree they are insured; furthermore, this should be centrally documented.

Embedding CRM in a holistic risk management

A well-organized counterparty credit risk mitigation should make CFOs and treasurers sleep better at night. However, it should not be treated as a dissociated process in Treasury. The risk management cycle described above should be applied to the most important Treasury areas, such as FX management, financial management and liquidity planning. Ideally, all departments feed into a fully integrated treasury reporting thanks to a mature and goal-driven IT environment.

Our Finance and Treasury Management team will gladly help you with any questions you may have concerning counterparty credit risk mitigation for treasury departments.

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Backtesting liquidity plans

Just how exact was your planning?

Finance and Treasury Management Switzerland

Have you ever backtested your liquidity planning and analyzed the discrepancies a bit closer? No? Most likely, most companies are in that position.
The truth is that existing liquidity plans often digress strongly from what happened eventually. Identifying the reasons and drivers for such discrepancies is usually not considered to be part of Corporatre Treasury's daily business, and sometimes the reason for a lack of backtesting lies in the scarcity of resources. However, looking back can sometimes be quite illuminating and make interdependencies even clearer. A systematic backtesting will divulge things that are unusual, anomalies and areas where the company could do better in future liquidity plans. So in fact, looking back can be quite useful for the future.

How accurate does liquidity planning have to be?

One of Treasury's core tasks is to ensure the company's continuous solvency. For this, determining the planned liquidity is indispensable. Generally speaking, it is sufficient to forecast the liquidity balance at the level of the corporation in order to quantify the financial leeway in consideration of financing mechanisms.

Discrepancies between the plan and the actual values are perfectly normal when planning a corporation's liquidity. It is practically impossible to prepare a plan that is of such accuracy that the predicted plan values are met exactly. And yet, a certain exactitude is elementary for any corporation in order not to drift off into insolvency but also to use the available capital efficiently.

In practice, liquidity planning often has to meet those very requirements; ideally, the plan's quality should be adequate. One could certainly discuss just how good the quality of the planning has to be; however, the reason for an unsatisfying liquidity plan can usually be found in methodical weaknesses in how the processes are applied in the day-to-day business.

Treasurers often grapple with on-going quality assurance when it comes to drawing up the liquidity plan. Observations show that there are often only few validation possibilities because the current data reports lack detail. This makes continuously improving the liquidity plan based on variance analyses practically impossible.

Another challenge in the liquidity planning is transparency. In practice, the underlying reasons for discrepancies and outliers can often not be traced back to their origin. Unfortunately, a reasonably exact analysis at the level of individual legal entities and liquidity positions would be important for a transparent liquidity planning. Planning processes that have grown historically and heterogeneous system landscapes also make things more challenging. All of this makes taking decisions when managing liquidity all the more difficult.

Finally, meeting the expectations of their audience is also of significance for reports. The planning method and system landscape very often only partially cover the stakeholders' expectations of the report.

Conditions for statistical analyses

One of the basic conditions for a quantitative analysis of the plan's quality is the availability of data at sufficient granularity for both planned as well as actual values. The longer the period of the data, the more exact the ensuing analyses will be. As a rule, planned and actual data should exist for a full calendar year, i.e. a complete planning period.

Normally the planned cash flows come from the pertinent liquidity planning system or from the Controller's budget. Ideally, actual data are readily available, for instance from the Treasury Management System, the ERP system or the banking tool. As an alternative, actual data may be compiled from Accounts Payable/Accounts Receivable (AP/AR) as well as HR and Treasury payments.

Backtesting approach

A quantitative backtesting can analyze the discrepancies between planned and actual data from the liquidity planning in order to systematically identify deviations at the level of legal entities, liquidity positions or periods. The statistical analysis of discrepancies and abnormalities and the related interpretation of the results can then be categorized according to different indicators, for instance systematic deviations, seasonal factors, one-off effects, etc.

An important category are systematic deviations. This involves identifying ongoing planning deviations that indicate systematic planning errors (example: planned amounts that are constantly too low or too high for a specific liquidity position or legal entity for a specific period).

Seasonal factors are indicators from repeated patterns of discrepancies between actual and planned figures, which indicate incorrect value date assumptions in the planning.

And finally, there are the one-off effects, which can also be measured using a key figure as an indicator. One-off effects describe the identification of individual, exceptional deviations between planned and actual figures, which are caused by frequent, exceptionally low or high plan values within a period (depending on the number of standard deviations).

Together, these indicators help analyze an enormous mass of data from the liquidity planning at an even higher granularity. This allows for a more in-depth interpretation of the results and relevant recommended actions.

Results

In order to obtain viable insights from the statistical analyses for both the liquidity planning and the corporation itself, the analyses have to be interpreted correctly and put into the context of the company-specific characteristics. At first, the mass of data (depending on the liquidity plan's granularity) may make an analysis of the results seem rather complex. However, all of this data is important in order to draw the right conclusions from the backtesting.

By implementing the deviation indicators listed above, the jumble of numbers in the liquidity planning suddenly becomes absolutely transparent. Seasonal factors, one-off effects and systematic deviations can be quickly identified and analyzed. These indicators, in turn, also allow an interpretation with specific actions in order to remedy the reasons for the high discrepancies in the liquidity planning.

Qualitative dimensions

In order to analyze and eliminate any deviations between an existing liquidity plan and the actual figures, backtesting is a comprehensive approach. Very often, the reasons for planning inaccuracies exist already much earlier before the planning data is even generated. Another dimension is necessary in order to look at a liquidity plan holistically and to uncover all of the potential for improvement regarding the planning's quality: a qualitative review.

The basic elements of a qualitative review are:

- Data (entry in the database, evaluation of the quality of the data)
- Methods (direct versus indirect approach, definition of planning parameters, plan's structure of liquidity positions, planning period)
- System-related (technical implementation, functionalities of IT systems, connectivity between interfaces)

If one looks at the qualitative and quantitative (backtesting) dimensions of liquidity planning overall, you can make detailed observations on planning quality, deviations and their causes.

Conclusion

As mentioned at the beginning, looking back is good practice for Corporate Treasurers when it comes to their liquidity plan. Backtesting can take on different forms and levels of detail. What is of importance is that the insights are interpreted correctly and used in future liquidity plans. Making plans more accurate is also good for the corporation's solvency. Another advantage is that the structured knowledge of the interrelations allows for a better scenario analysis and simulations. This enables a more precise analysis of the liquidity requirements and the necessary liquidity buffer. Besides allowing a more efficient allocation of capital, an increase in transparency on liquidity in the corporation is the most obvious advantage of backtesting.

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