**INTRO**:

Welcome to the Treasury Update Podcast presented by Strategic Treasurer, your source for interesting treasury news and analysis and insights in your car, at the gym, or wherever you decide to tune in.

**Meredith**:

Welcome to the Treasury Update Podcast. I'm Meredith Zonsius, communications manager at Strategic Treasurer and today's host. Our featured speaker is Craig Jeffery, our managing partner and founder. Today we're excited to cover some of the most frequently asked questions in treasury. So far we have released podcasts on the first and second round of FAQs submitted by various treasury and finance professionals. Today, we continue with FAQs and treasury round three covering treasury topics around hedging, finance, accounting, and more. Welcome to the show Craig.

**Craig**:

Hello Meredith.

**Meredith**:

To kick off round three, does accounting matter in treasury, where does accounting matter in treasury and should treasury book the accounting entries?

**Craig**:

Well, I'll try to answer them fairly concisely, which is against my nature. Almost everything treasury does finds a home in a banking system or in accounting entries as a way of recording it. I mean accounting is the language of financial recording, so obviously treasury is moving funds, receiving items, making investments, accruing interest, et Cetera, so that it matters in treasury for all the transactions of course. But I think to your other question, should treasury book the accounting entries or what the question is that, people have asked this several different ways is, does treasure have to book it, or does accounting or some other area book accounting entries, do you have to the sub-ledger book entries and not book anything in treasury? So, I'll touch on a couple of areas as like initially, I don't really care where you book accounting entries.

I say that a little bit flippantly. It's running treasury groups. My area had to book accounting entries. I don't care if treasury books them or not. I think there's a couple of considerations that you need to think about it. One is, there is a sense of segregation of duties who's performing certain transactions. Someone separate has to book that. Does that need to be outside of treasury or inside? Some of that is driven by size of the organization and activities and functions so that that box has to be ticked. The second is that it should be booked in an automated fashion as much as possible. And so if you have a banking platform, you have a treasury management system that can run logic and book those entries and then feed the General Ledger, that makes sense. If it can act as the true cash book keeping track of a full ledger, that can be great.

And that the treasury system that you're using, does treasury have to be the one who actually records entries or codes the system to generate those entries? No, it doesn't have to be. Maybe they do it because they're more familiar with the system and it's reviewed by an accounting or a GL group. That's perfectly fine. But the system should book those. I think the other part of that, how should they be booked? And we think about there was a long time when accounting was called "treasury" in ancient Egypt, et cetera. And accounting was done by lists. And then there was the invention of double entry accounting. I'm not going to bore people with how that was set up, but double entry accounting allowed for a great process of balancing activities. Every debit has a credit, you can make sure certain things are missing and provided nice controls and that worked particularly in a unautomated world.

It just made sure things matched and worked quite well. Obviously double entry accounting still works, but sometimes there are multiple sources of that. I don't necessarily want to create a term of triangulated accounting, but you know I said earlier is like AR is booking things or getting a feed from the bank. They're booking things in their accounts receivable sub-ledger and they're, they might be hitting cash while treasury is also receiving that information into their cash sub-ledger and they can either book an entry or not book an entry, suppress it and feed it or not feed it to the General Ledger. And I think when you have fully automated systems, this idea of, and I'm going to, I guess keep using that term, triangulated accounting is treasury can, and in most cases should, book everything that flows to the banking system. I mean obviously investments, if they're tracking investments, they're not an insurance company.

I'm an investment, a accounting group. They're tracking debt, they're booking things. They're, they're going to book those, but all of the operating activity, which for some organizations may be admin system related, it may be accounts receivable, maybe accounts payable related. They see stuff coming through the bank system and instead of letting that information hit the floor, suppressing it, they can book it to cash in a clearing account too that's designated to a particular area like AR. AR Can receive their file to post and relieve AR and they could book it to a cash clearing as an example, cash clearing for their particular area and that would be that matching process of cash clearing allows treasury to book all cash through the system and it's done in an automated basis. It's done on a comprehensive basis. And what's done in AR for example, is they're booking everything they get maybe from a lockbox feed or a digital feed.

They're booking and clearing their receivables. And the other point on that is that the cash clearing for GAAP purposes for accounting purposes would also be treated as cash, but they would wipe each other out, they'd be designated to a particular area. That way you have complete booking of everything that hits the bank on an automated basis, and you have everything that comes from a feed, perhaps from a bank or a third party system that's receiving it booked from the sub-ledger system. That way that cash clearing account handles it. You'll see any discrepancy noted there. That is certainly what most leading companies are doing and you can't do that if things are manual. That's just way too many entries. But in today's world where we can automate both sides, it can identify and create a process that is much more easier to see when there is a problem or discrepancy rather than only waiting for cash or, or bank reconciliation to discover that 10, 20 days after the month end close or perhaps several months later.

So maybe I'm introducing firm triangulated accounting, but other people say that's just clearing accounts.

**Meredith**:

Do you want your hedges to make money?

**Craig**:

Generally? No. what's the purpose of hedging and risk management in treasury? For most organizations like corporations, the purpose is to reduce your volatility or reduce your exposures to bring them in line with not only your risk capacity, which may be pretty large, but your risk appetite, what you're willing to bear. And so you're trying to reduce the volatility and producing volatility is a different model than if you're in a hedge fund. Hedge Fund will take positions on things, a hedge fund will take positions on what's going to occur with FX movements or the price of commodity or oil that's their business, is betting on those things or having a view to the market. Whereas most treasury groups, most treasury organizations, their goal is to reduce volatility and bring it in line.

So that's a general background for it. But your question is do you want your hedges to make money? Someone says we would've done better if we didn't hedge, the hedge was out of the money and lost money. Well, what were you trying to do? You were trying to bring your exposure in line, you didn't want to suffer a loss of a certain size, so therefore it made sense to hedge use a financial instrument to reduce that volatility. And that I think is important to know. You're trying to reduce your exposure and bring it in line with your risk appetite and in line with the policies that you have. Now normally your hedging a portion of what your exposure is, so it's only a certain portion of it. So you have an underlying exposure, let's say variable interest rates on some debt you have, your exposure is interest rates could go up, whatever your base is.

Maybe it's based off a LIBOR or SONIA, so for whatever it's based off of a new standard, let's say. And those rates go up well then now you're exposed to paying more for your debt. Maybe you don't want the full exposure. If interest rates go up 2% maybe you only want to bear half of that, or 1% let's say for example, so you put an interest rate swap in for 50% or maybe 70% whatever the number is, but typically you're not hedging 100% right? You're not hedging 100% you're hedging some portion. So if your hedges make money, your underlying exposure loses money and your underlying exposure is in most cases larger than what your hedge coverage is. If you made a thousand dollars or a million dollars on your hedge, you might've lost $2 million on your underlying exposure. And I'd rather not make money on the hedge.

Most people wouldn't want to make money on the hedge for that type of reason. If that's the focus of your hedging. Now that's not the only answer. Maybe you're hedging, you're reducing volatility to bring it in line with that. And also could be that you're hedging to present yourself in a better financial situation than your competitors and trying events. So maybe your competitors aren't hedging and you're hedging 75% and so making money with your hedges means you lost on the underline, but it's muted because every $4 of a loss on your underlying exposure, interest rates or commodity price variations, it means you get $3 from your hedge. So $100 means only a $25 loss. Well, you don't necessarily want that loss, but maybe positionally you want to do better than your competitors because you see it as volatile. That's a position of strength or whatever you're doing.

If that's what you're doing, then perhaps you want your hedges to make money. So I only see it if it's a competitive position and it advantages you because you reduced your exposure there or because you're a hedge fund, but usually you don't want your hedges to make money and it's an insurance factor. So you don't say, I want to make claims on my insurance policy. No, you don't want that accident in your car to claim it. You still have underlying loss. You pay the deductible. it's the same type of concept with hedges.

**Meredith**:

Would you say there is any differences between privately-held companies and publicly-traded companies in that regard?

**Craig**:

Yeah, there certainly can, that's a really good question. So that that goes down to why do you hedge and do you want to qualify for hedge accounting purposes? So a public firm, well, any firm has an economic aspect of hedging. I want to reduce the actual financial loss over time and that's when you put the hedge on for economic purposes. Now there is also an accounting feedback loop, I'll call it, with hedge accounting based on effectiveness and ineffectiveness of the hedge. How well did it the hedge do what it's reported on. I'm not going to go into all of what can cause that, but the effective portion of the hedge, if you've qualified for hedge accounting in summary terms can roll through an element of the balance sheet, usually referred to as other comprehensive income. It's in the balance sheet rolling through that, that category.

And then it gets released to the income statement according to a schedule and according to terms based on which accounting regime is being used to do that. What that means is if part of your hedge is ineffective or all of your hedges ineffective, you don't care to qualify for hedge accounting. All of that element impacts your income statement right away. So while the economics may be ideal for what you're doing, there's a feedback loop into the accounting records, so everything shows up in your income statement. It's not slowed down through a like a water retention pond, right? When there's a flood, stuff flows there and it releases into the lake eliminating the flood. Well, OCI is that retention pond that releases that can release it more slowly. Now when it releases it quickly, it has an impact of volatility on the income statement, not economically, but the income statement.

And that can change how companies value how people and investors value companies because they want to see nice steady earnings as gradual trend up. They want it smooth. And so there's a, there is a feedback loop to hedge accounting that can exacerbate the situation or moderate what they're trying to do, not economically, but from a reporting standpoint, which has a another economic benefit of organizations investing in those companies. I don't know if that made sense or if that was just a lot?

**Meredith**:

No, it does! Thanks for sharing. Do you want more working capital or less?

**Craig**:

Yeah, this is, that question is made up of a lot of different feedback elements. I'll say depends what your definition of working capital is. The accounting and banking definition is current assets minus current liabilities. So in that definition you want more current assets than current liabilities. So you'd want more, more cash, more receivable because that shows your ability to meet funds and requirements, financial requirements as they come due.

So that's a measurement that yes, you would want more working capital or generally you'd want more working capital rather than less. So what Treasury looks at are those that are managing working capital, the cash conversion cycle. Look at, they look at a formula of accounts receivable plus inventory minus accounts payable, and this certainly it doesn't have cash in it. So converting an accounts receivable to cash is viewed more positively. Every treasurer knows that's better to have cash versus a receivable. actually every person knows that that's, that's better when you're looking at it from that perspective. So this is how much cash is tied up in your cash conversion cycle and how much cash you have tied up in that is a reflection of how efficient are your financial processes. You can have accounts receivable grow very large and that will increase net adjusted working capital or working capital from the accounting definition.

That could mean you're collecting slowly. You have terrible terms, it can mean a number of things. So you don't necessarily want more or less there. You want to make sure that it's balanced and optimized. So you want to set fair terms, you wanna make sure you're collecting properly. You want to make sure you're converting cash to goods, you know from inventory to goods selling it, convergence and receivables, kind of bring it back to cash and at the same time paying with whatever terms make sense. So you may want less working capital without definition, collect faster instead of an average of 45 days when your terms are 30 you want to make your collections more efficient, but you do want to optimize it. You don't want to just reduce inventory down to nothing. In most businesses, you want to make sure that there's a process that is efficient and a process that helps you sell.

You have no, no washers and dryers in your, in your warehouse and it'll take five days to deliver it. Someone whose washer breaks like a situation I had some time ago, it broke and a one place was managing inventory very tightly and I think we could, we could get the washer on Thursday. I think it was a number of days, whereas another place buying it on the weekend, I can have delivered Monday morning. I would have been in great trouble if it took me four days to get a washer and I was in the clear if laundry would only pile up for a few days by getting a washer on Monday. So that can impact sales. I have more color choices, I have physical goods that can be picked up or it can be delivered within a certain period of time that provides ability to increase sales, manage risk, et cetera. So it's a method of optimizing each of these, optimizing your terms so that working capital makes sense.

So traditional definition, current assets minus current liabilities, the accounting definition, usually you'll want more, the others, it depends. But you certainly want to optimize working capital using the treasury definition of how we manage the cash conversion cycle.

**Meredith**:

That's helpful information on working capital. And the final question, what are the different perspectives on finance?

**Craig**:

Yeah, some of the different finance perspectives where you look what you're doing, what the purpose is, tells a story that's important. And I'll be quick, but just a couple things and I don't want to overgeneralize it, but what's the primary purpose of, let's look at the controller's group and the accounting group. So the controllers group is mainly concerned about financial reporting and that the controls they have will detect issues. And a lot of those are driven through a financial statements. So the primary focus is financial recording, a historical look, what's going on, making sure everything's recorded properly in time, and that the system would detect any type of control issue and you'd be able to find it, have a good audit trail, et cetera.

And there's clearly some elements of looking forward from that perspective, planning and making sure things exist, but the primary orientation is financial reporting and historical. In treasury, the primary orientation is forward, looks to the future, what will our balance sheet need to look like, how much cash do we need to have? And so they're, they're looking there and then this might be a short term forecast out six months, it might be capital planning out two or three years. And so their orientation is forward. It's focused on liquidity and what's coming around the corner. And yes, they have to look back to do forecasts. And so they look back just like the controllers groups looked forward, but their primary orientation is forward. Together, they accomplish many of the key elements of finance. Now the FP&A group is one other area I'll talk about, since you relayed the range of questions that talked about the, what do you refer to it, the perspectives on treasury or the direction of the look?

I guess it was perspective. Yeah. So FP&A primarily looks forward, it looks forward far and looks forward in large time domains to see what, what the income will look like in that period of time. What will our profit margin be. And so they will look in that with that orientation. And while there's been a lot of progress with some of the tools that FP&A uses to say, yes, we have an income statement orientation, a profit orientation, and we can back into what that will do to the cash side. That's a more recent development. and it's maturing. It's probably not a teenager yet, but there's, there's definitely some progress there that that exists, but their orientation is income statement, long timeframes and large buckets and treasury when treasury looks forward a long time they're looking for what is our, do we have enough capital and cash access to credit to meet those needs over time.

**Meredith**:

Thanks for this informative interview Craig. For our listeners, thanks for tuning in to the Treasury Update Podcast. If you would like to listen to the first and second round of FAQs and treasury, visit us at strategictreasurer.com/podcast. Thanks for your support.

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