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And Yet It Moves!

Corporate Treasury

While IFRS 9 brought significant new rules for classification, valuation and value adjustments, the transition from IAS 39 to the new standard did not seem to affect liabilities. However, in July 2017 the IASB stated that the new rules will apply retroactively for the valuation of loans payable at amortized cost. This specifically concerns cases with unrecognized changes in cash flows.

The contractual adjustment of financial debts is something that rarely takes place at most companies and is then only accounted for at the time the of the signing process. This gave the impression that something had changed but that this was something that would have to be applied only occasionally (i.e. whenever there was an amendment in contracts). However, because of the retrospective application of IFRS 9, this means that many more financial debts could be affected.

To make the situation clearer, it has to be understood that there are two kinds of changes in financial debts that could affect how they are recognized in the balance sheet and disclosed in the income statement. Either the expected cash flows change because of contractual rules (for example, if termination rights were exercised but not recognized separately) or the contract is amended legally and the cash flows change due to these changes (for instance, because the parties agreed on a shorter maturity and repayment is expected earlier). In the latter case, i.e. the contractual amendments that cause a difference in cash flows, it must be decided whether these contractual amendments are significant or not. If they are significant, then the former debt must be derecognized and a new debt must recognized. In cases where the amendments were insignificant, up to now the debt was recognized in the balance sheet (minimizing the impact on earnings) and the actual interest rate was adjusted.

However, IFRS 9 defines the recognition in the balance sheet of refinancing that does not lead to a final derecognition of the existing liability. In case of an insignificant amendment, IFRS foresees maintaining the original actual interest rate; the discounting of changed cash flows therefore causes an increase in amortized cost, which will also impact the income statement, just like adjustments of cash flow which up to now were addressed in IAS 39 AG 8. In practice, companies handled this procedure by changing the actual interest rate in case of insignificant amendments so that earnings would remain unaffected. This is applies also to financial assets; however, for most corporations, this topic will probably be of more interest on the liabilities side.

Upon the initial application of IFRS 9 as at 1 January 2018, all outstanding cash flows of existing financial instruments which had been modified in the past without causing a derecognition must be discounted using the effective interest rate applicable as at the time the item was captured the first

time. The difference to the carrying value as at 31.12.2017 must be captured in revenue reserves. Due to the amortization, the original effective interest rate rather than the current one will then impact the income statement during the remaining term.

In a first step, for companies this means having to establish the circumstances (financial instruments which were amended in the past, which were valued at amortized cost, as well as the original effective interest rate). Until the time of adoption comes, in a second step, scenarios should be run to determine the impact on the balance sheet as well as on the interest income to be disclosed.

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Treasury 2025

What needs to be done already now

Corporate Treasury

In our article of 28 July 2017 we already spoke of the opportunities and risks awaiting Treasury over the next 5-10 years.

Part 1 of this article already highlighted in detail the topics automation of standard processes (e.g. FX exposure management) and digital decision-making. Our conclusion showed the opportunities to seize and also how important it is to act in a timely manner. It is only if it makes processes leaner and more homogeneous that a company can benefit from standardization and the possibilities afforded by digitization in the future. But more can be done to tap the full potential. We will show you what will change and how by focusing on two topics:

Embedded compliance as a standard

Compliance is becoming an increasingly big topic. While the requirements made of internal compliance in Treasury has only changed slightly in the last few years, external compliance has undergone major changes. A CEO mentioned during a discussion that the regulations and legal aspects of all the countries and the international organizations are impossible to know, which is why he was constantly on the brink of going to jail, let alone the reputational and financial damages the company was entering into unknowingly. Clearly, the biggest issue with compliance is the human being, either because they cheat on purpose, misread situations, don't know or simply make mistakes.

Of course, Treasury 4.0 does not solve this problem once and for all but the automation of processes and their integration into systems along the entire process chain is a prerequisite for embedding compliance.

Embedded compliance means that both internal and external compliance requirements are mapped using automated routine reviews and controls in the systems, thus allowing for real-time reviews and ensuring that external third parties are notified completely and correctly. The target is to eliminate the human factor in this standard procedure. Let's look at three examples:

1. Supervision of exposure limits (internal compliance): compliance with a certain hedging ratio required by the strategic specification can be checked immediately; the moment a deviation defined beforehand takes place, Management will be informed automatically. A monthly reporting that many Treasury departments still have is thus rendered obsolete.

2. Payment operations (internal / external compliance): If in the past decentralized payment operations made it hard to recognize internal or external fraud let alone prevent it, the prevention of such fraudulent actions has become practically impossible with the new highly automated and centralized processes. The solution is called artificial intelligence (AI), AI (or rather machine learning, to be more precise) recognizes anomalies and if a payment is not deemed "normal", it is automatically marked for manual processing. This procedure is based

on the assumption that machines recognize anomalies better than human beings. However, this procedure not only identifies fraud but also corruption and money laundering, two external compliance topics where breaches can cause massive fines.

3. EMIR reporting (external compliance): If the system ensures that all relevant transactions in the centralized database are not only available but also meet regulatory requirements, the system can make sure that any deviations from the ideal process (e.g. target times) are escalated and documented immediately, without requiring further employee action. The same is true for the relevant notification duties. If the institution does not comply in this area, the system recognizes this and initiates relevant steps.

Taking these three examples it should become clearer that embedded compliance is more than just a buzzword and that it is safer if a machine performs the process rather than an employee.

It is not at all necessary to wait until a system environment becomes available that can do all this to perfection. You can already begin with automating controls in existing systems as well as the relevant compliance reporting wherever possible.

Performance becomes a quality indicator

All business departments are subject to detailed performance measurements. All departments? Not quite. There is that little exception called Treasury that is generally still exempted from having its performance measured. The reasons are irrelevant in this context.

Slowly but surely changes are becoming evident. For instance, there is an increasing interest in bank fee management or the performance measurement related to currency management, including the relevant cost/benefit ratios. Add to this the changing processes, such as payment operations, which lead to process chains that reach far beyond Treasury, and which are therefore subject to a performance measurement. Cash management and payment operations processes are good examples of processes that can be handled by Shared Service Centers. Key ratios in real time, such as lead times, transactions per employee, hedging costs in relationship to the achieved reduction of volatility of the currency result, backtesting of scenario analyses - the examples could go on and on.

However, it is not always a lack of will that this was not tackled in the past; rather there were limits as to what was doable from a technical point of view until now.

However, this has evolved rapidly. Central (and up-to-date) data availability is no longer subject to notable restrictions, neither from a technical nor a financial point of view. Nonetheless, getting there may take longer or shorter and cause more or less effort, depending on where the starting point is.

Despite all of this, there is no reason why this should not already be started today.

- Designing a comprehensive KPI concept, lobbying for their acceptance in the company and integrating them in the reporting,
- Defining the requirements of the data involved and wherever this already possible, implementing these now.

So these were two topics of Treasury 4.0 which have brought the future closer by looking at standard topics and by checking whether these can already be implemented today. Of course, a nice theory is not practice, which is why we will look at the implementation in the coming newsletter.

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Treasury 4.0

Where does your Treasury stand and what are the next steps?

Corporate Treasury

We have been writing about trends, impacts and challenges affecting Treasury 4.0 for several years now. The topic continues to be of relevance - both regarding the interest it generates and the necessity to rethink certain aspects. Questions surrounding Treasury 4.0 just keep on coming, bringing to the fore new technologies, buzzwords and viewpoints. Last year blockchain and fintech were the hotly debated subjects, while this year artificial intelligence seems to have become the major talking point. Despite these discussions, many Treasury departments still seem a bit overwhelmed by all these dynamics and hardly know where to begin making use of these new concepts in their daily operations.

Going Classic: Treasury 4.0 Gap Analysis

Where can companies begin to climb the mighty peak called Treasury 4.0 without losing sight of the ongoing, short-term challenges?

First of all, the treasurer must grapple with the following question: "What should the result be for our treasury department?" The answer to this question will sketch the target for Treasury 4.0 in broad strokes.

The next question then is: "How do we get there?" As a rule, there are two ways how companies can define the position of their treasury department and new approaches: they can either set up an internal project team that will tackle such issues exclusively for a period of time or do it on top of handling their normal day-to-day chores or they can mandate an external consultant to tailor a Treasury 4.0 concept for your specific company and its implementation, in collaboration with your company. The first scenario has the advantage that your own people dispose of knowledge coming from several functions. Not only Treasury has to grapple with trends and challenges such as automation, digitalization, embedded compliance and performance as a quality indicator. Other departments, such as Accounting or Procurement, have to deal with very similar questions. However, what is essential is that departments should not work on processes and topics on their own but rather under the close supervision of a project manager, a project plan and with the targets defined above in mind. This enables a certain harmonization and a standardization of all initiatives surrounding Industry 4.0.

External consultants will proceed similarly: First of all, they determine the positioning of the treasury department with the help of a questionnaire or an assessment. They then map the results from these evaluations and analyses by using modern workshop methods, such as Design Thinking, into a Treasury road map.

In the end, they should be able to present Treasury with a list consisting of development and change measures, taking into consideration the implementation costs depending on topics, prioritized according to urgency, complexity and relevance.

The Fast-Track Approach: KPMG Treasury 4.0 Readiness Assessment

KPMG has developed a Treasury 4.0 Readiness Assessment based on an online questionnaire. The assessment contains 65 questions on Treasury 4.0 from five different maturity level dimensions. The evaluation concentrates on the following areas:

- How well the treasury strategy and its IT as well as its operating model translate into the future
- Requirements made of Treasury staff and new competences required of them
- Efficiency and effectiveness required of Treasury processes and methods

For instance, one of the five dimensions is "Strategic Orientation". Answering all of the questions on this dimension will inform how the Treasury strategy, the operating model and technologies have to harmonize and to what degree Treasury 4.0 elements have already been realized. Another dimension, "Systems & Processes" shows whether data is being made available and processed using flexible and scalable systems and to what degree the company uses suitable methods and tools to analyze and evaluate data. An analysis of the five dimensions will show Treasury where it stands, how it compares to peers and where it should act. The results will then be presented as a graph: the information on the maturity level dimensions are presented on a value scale for each point and compared to other parameters. For Treasury, the current maturity level of Treasury's IT is the basis on which the best practices for many processes are designed.

This method enables a multi-dimensional picture that shows in which areas there is a need for action, which strengths the company should maintain and expand and where other companies are ahead of the game. Based on this, a detailed evaluation of the efficiency and effectiveness of all Treasury-relevant processes in the company in order to attain Treasury 4.0 levels can be made.

Conclusion

Which way they choose to go is up to the company but what is clear is that eventually they will have to move forward in this area, one way or another. Technology, regulations, restructurings and new business models are all pushing big changes in Treasury, which means that Treasury will not only be faced with the day-to-day operations but also with numerous emerging additional tasks that will affect Treasury immediately, such as the ones defined by and for Controlling, Procurement and Sales.

For more information on the Treasury 4.0 Readiness Assessment, please click on https://atlas.kpmg.de/business-assessments/treasury-4-0.html