The Corporate Treasurer

Plotting a course through risk and reward
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The Corporate Treasurers’ role and remit has expanded considerably in the years following the financial crisis. With financial risk management accorded top priority, the Treasurer’s key role in areas above and beyond the traditional focus on transactions means treasurers have greater involvement and influence across a broad range of business activities.

Accordingly, this resource sets out some of the key issues to which EY believes treasurers will need to pay increasingly close attention. They range from assessing the options available from capital markets that offer unprecedented diversity of funds, to working with tax teams to ensure that intra-group financing is able to withstand the increasingly close scrutiny to which it is subject by revenue authorities around the world.

As the pressures and demands on the treasury function mount, we examine the increasingly wide range of skills and resources that Corporate Treasurers at leading corporates are calling on to manage their widening responsibilities. These include the specialised knowledge associated with new accounting standards for financial instruments, to the development and implementation of strategies to optimise working capital and from supporting effective execution of M&A transactions to managing the financial risks in increasingly complex supply chains.

The treasury function is becoming an ever-more integral part of every business’s ability to manage the wide variety of financial risks that it faces. In response, treasurers will need to make sure that they can continue to meet the growing demands placed on their organisation.

The developing role of the Corporate Treasurer

The treasury function continues to be central to the successful management of financial risk.
Steering a course through volatility

Corporate Treasurers face risks to financial and liquidity management arising from, among others, volatility in commodity markets, foreign currency fluctuations and uncertainty about when interest rates will start to rise. With all businesses increasingly exposed to developments and events in the global economy, Corporate Treasurers need to ensure that they monitor and manage a far wider array of risk indicators than ever before.

While the current relatively positive economic outlook for the UK is in marked contrast to just a few years ago, major economic uncertainties remain in the broader global economy. These range from political instability in the Middle East to concerns about the future of Greece as a member of the Eurozone, and from questions about China’s growth rate to the timing and outcome of a UK referendum on continuing membership of the EU.

In contrast, there is better news arriving from a number of Eurozone economies that, for the first time after several years of flat-lining, are reporting growth and appear to be benefitting from the ECB’s quantitative easing programme. In line with this, European property and equity markets are also recovering and consumer confidence is growing – albeit from a low base.

However, as the sudden, sharp and unpredicted decline in the oil price demonstrated, a shock may be around the corner at any moment. In the post financial crisis environment Corporate Treasurers have a key role to play in ensuring that their business is managing the full range of risks that the global economy will continue to generate.
M&A – Treasury’s key role in delivering deal success

As corporate M&A activity increases, an expanding volume of transactions is creating a larger role for Corporate Treasurers and their teams. Yet, as by their very nature mergers and acquisitions tend to be unplanned and outside the scope of day-to-day operations, Treasurers need to be able to find ways to manage a sudden increase in the resources, expertise and experience they can call on to make sure that they are able to play the role required of them at all stages of a deal’s progress. Adding further complexity is the increasingly international nature of proposed transactions, taking in multiple entities across a large number of jurisdictions.

A typical transaction has three main phases: pre-deal analysis, contracting and post-deal integration. Treasury has a key role to play in each phase of the deal lifecycle. Right from the outset, treasury input can have a significant influence on the success of a transaction; from how the deal is constructed and funded, assessing the potential risks from, for example, FX volatility or trapped cash, through to post-close integration to ensure that target and acquirer treasury operations form an optimal fit. Asking the right questions about a target’s treasury function is therefore essential for closing a deal effectively and achieving effective integration. A large proportion of transactions fail to generate the benefits that they promise, and much of that shortfall is a result of failures in post-acquisition integration.
To support the business in achieving the desired results from a transaction, treasury teams need to ask a range of key questions about treasury operations; capital markets and funding; cash management as well as accounting and reporting. Making sure that they can provide the insights and analysis that will secure the best possible outcome requires treasurers to consider how they can support a deal with the appropriately skilled and experienced resources at the same time as maintaining business as usual operations. It’s a significant challenge. But as deal activity increases, its one for which treasurers must find a sustainable and effective solution.

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Corporate Treasurers increasingly need to manage complexity and volatility on multiple fronts. Hedging exposure to financial risks such as currency fluctuations, interest rate uncertainties, inflation and commodity price changes requires the use of sophisticated financial instruments. The accounting and valuation activity those instruments require is also highly technical. Its inherent complexity is compounded by a fast-changing accounting environment, with the introduction of new UK GAAP (in particular standards such as FRS 101 and 102) and IFRS 9.

Having access to the relevant skills to value and account for derivatives is essential to ensure successful month-end close and avoid adverse impacts on disclosure and, ultimately, the bottom line. But as those skills are not often found among the usual repertoire of the treasury team, identifying the best way to access them can be a headache for Corporate Treasurers.

Of course, those specialist skills and know-how are available on the open market – but they come at a price. What’s more, as these are not capabilities that will be put to use everyday, relevant talent may find their underutilisation demotivating, spurring them to look for opportunities where their skills are likely to be more consistently deployed.
An alternative approach is to work with a third party. A specialist provider, focused on the accounting treatment and valuation of complex derivatives, can provide treasurers with dedicated expertise and resources. Know-how and skills are constantly updated, providing coverage across the latest standards and can help to achieve reporting results more cost effectively and maintain pace with a fast-developing and technically demanding environment.

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Corporate funding – never had it so good?

The debt markets today present something of a contradictory picture for corporates. Spreads have risen considerably since the credit crunch, in some cases by as much as two to three times. On the other hand, base rates are at historic lows, which has compensated for the rise in spreads and with them trending down again somewhat in the last 18 months, there’s arguably rarely been a better time for corporates to lock-in funding for the long-term.

The lender and investor universe has also witnessed enormous change. As banks have retrenched, partly through choice and partly due to regulatory requirements, higher spreads have attracted new and existing lenders to fill the space left behind.

This increased competition means that corporates have access to a far broader array of capital providers than ever before. For example, established players such as US private placement funds are increasingly active in direct lending, giving corporates with the right credit metrics access to long-dated money in smaller tranches than have previously been available. An example of this new diversity is highlighted in how the mid-market leveraged loan market, traditionally heavily dependent on bank financing, is now increasingly availing itself of these new sources of capital. In short, opportunities are not restricted to high-grade candidates; new providers are lending across the leverage spectrum, with a plethora of new funding platforms emerging for mid-market businesses and even start-ups.
The fierce competition that these new providers introduce to the market means that funding choices available to Corporate Treasurers are wider than they have ever been. So when it comes to the question: ‘Never had it so good?’ the answer is probably a qualified ‘yes’. Of course, with greater diversity comes higher complexity. Corporate Treasurers will need a knowledgeable guide to help them find the optimal products from the most suitable provider. But in an environment subject to rapid change, there’s little doubt that the time is right to lock-in the opportunities afforded in today’s markets.

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Financial transactions
Transfer pricing

For some time now, intra-group financial transactions, including those carried out via a centralised treasury operation, have been under increasing scrutiny from tax authorities. This trend is set to intensify with intra-group financial transactions and captive finance companies being key areas of focus of the OECD’s Base Erosion and Profit Sharing Action Plan (or BEPS). As custodians of intra-group finances, treasurers at leading corporates are working more closely than ever with their tax colleagues to ensure they have robust transfer pricing policies in respect of their treasury activities which will minimise the risk of tax audits, tax adjustments and reputational risk in the post BEPS environment.

There are three key elements to this. Firstly, groups need to design and implement globally consistent transfer pricing methodologies covering all of their intra-group financial transactions. Secondly, these need to be documented in accordance with the latest tax authority expectations including via the Masterfile/Local File concept. Thirdly, groups need to develop a strategy for dealing with tax audits, including for the relief of double taxation, which again will require treasury personnel to work closely with their tax colleagues.

Tax authority expectations with regard to transfer pricing policies vary, and there is little consensus and available guidance. So when
designing transfer pricing policies corporates need to have insights into differing tax authority expectations with regard to matters such the pricing of intra-group loans.

One of the key BEPS demands is for documentation that can be shared between multiple tax authorities. This needs to provide complete transparency into what transactions are, how they are priced and where the profits are being recorded.

A global corporate may have many hundreds of entities around the world, which between them may have thousands of transactions. Reviewing and aligning all their agreements is no small undertaking.

Even with well designed and implemented policies and robust documentation, corporates are likely to face tax audits on aspects of their intra-group financial transactions. They need to understand the full range of options available to them for dealing with these, and for the relief of any double taxation which may result.

So where to begin? EY has found that a meeting between key tax and treasury personnel and advisers is a good starting point to help identify key risks and opportunities. Reviewing the changing global landscape as a single team can enable tax and treasury personnel to gauge their potential vulnerability to challenge in respect of their intra-group financial transactions and agree an action plan to manage these.

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IFRS 9 – reintroducing flexibility into Risk management

With the introduction of the new financial instruments accounting standard IFRS 9, we have what is the first risk management friendly standard. IFRS 9 will replace IAS 39 in its entirety.

It represents a major opportunity for Corporate Treasurers to review their approach to risk management and rethink the way they manage risk and the type of instruments that they use.

In the past, the use of certain hedging instruments gave rise to potentially adverse accounting i.e., volatility in the financial statements. The misalignment between optimum economic risk management and the associated accounting has had very real impacts on working capital and earnings due to potentially sub-optimal strategies.

IFRS 9 eases many of the accounting obstacles giving Corporate Treasurers an opportunity to deploy the hedging instruments that best meet their risk management needs rather than those that suit the accounting requirements.
IFRS 9 has a mandatory adoption date of 1 January 2018. With EU endorsement expected in 2015 ¹, early adoption may be permissible for financial years ending in 2016.

There is a real window of opportunity to access the considerable benefits IFRS 9 offers to those looking to manage their risks in the most efficient and effective manner.

Now is the time to review current practice to ensure benefits of IFRS 9 are fully realised.

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1 EFRAG’s preliminary assessment is that IFRS 9 satisfies the criteria for endorsement for use in the EU and therefore recommends its endorsement
Supply chain financial risk – a new approach

The dramatic recent fall in oil prices has brought home the significant impact that fluctuations in commodity prices can have on a corporate’s overall financial performance. As well as volatility in commodity prices, supply chains are also exposed to, among others, foreign exchange fluctuations and uncertainty surrounding interest rates. Taken together, these represent significant financial risks.

In response, companies have pursued a number of approaches to address the financial risks in their supply chain. One standard practice has been to enter into fixed-price contracts that lock in a price with a supplier. However, these can prove very costly both in the event of a decisive shift in the commodity price and because many of the cost elements of a fixed-price contract – such as hedging, contingencies, insurable and non-insurable costs – remain hidden. Understanding those hidden cost components is therefore crucial to improving financial performance in the supply chain.
We are also seeing companies approaching the financial risks inherent in their supply chain through alternative hedging strategies using financial instruments from the market rather than relying on bilateral hedges with suppliers. Companies can achieve significant savings by switching their risk management in this way. One global electronics manufacturer, for example, reduced its annual procurement spend by 3% (equivalent to $20 million) by moving from bilateral to financial hedges.

Corporate Treasurers at leading businesses are playing a key role, in working with their procurement teams and finance functions to assess the overall financial risks in the supply chain and develop the optimal risk management strategies to address them. The introduction of a new accounting standard (IFRS 9) addressing financial instruments will open up possibilities to deploy a wider range of derivatives instruments. However, the new standard creates some complex accounting requirements. It’s essential, therefore, that Corporate Treasurers understand their application in order to derive maximum benefits from new opportunities to improve financial risk management in the supply chain.

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Pension deficits – picking the right strategy

Corporates’ defined benefit pension deficits are at all-time highs. A combination of quantitative easing in the Eurozone and the deflationary impact of the collapse in oil prices has driven UK Government Gilt yields to historically low levels, driving up liabilities. Many corporates with pensions to fund are now having to face up to the reality of interest rates being lower for longer and the real need to tackle liability funding.

Facing up to that reality means corporates and their Treasury teams are more closely scrutinising a range of options that offer ways to address the real cash liabilities that they face.

There are two main strands to liability management strategies. The first opportunity for management teams to consider is how to reduce actual liabilities. The new Pension Freedom rules have highlighted the opportunity for people to do different things with their pension savings and many corporates are looking at how best to capitalise on this market momentum perhaps through incentive exercises to manage down risk and liabilities.

The second strategy management teams are looking at is the ability to use special purpose vehicles (SPVs – in the form of Scottish Limited Partnerships) – that offer several benefits
including, no adverse accounting impacts, tax advantages or at the very least tax neutrality. However, their greatest benefit is the ability to convert a shorter-term pension deficit recovery plan into a longer-term recovery plan through the use of collateral to significantly reduce annual cash outflows. Treasurers have been exploring using SPVs with a range of income-producing assets. Recent innovations include the use of intellectual property and intragroup receivables. As well as the employer funding benefit an additional benefit is that the SPVs’ accounting treatment enables the pension scheme to report themselves as being fully funded, as the contractual future income can be recognised upfront as an asset.

When they are assessing the very real need to address their liabilities, EY would urge treasurers to ask the following questions:

► Do you understand the risks and volatility in your pension scheme?

► Have you thought about the opportunities arising from Pension Freedom?

► Have you thought about alternative structures and assets to fund your pension liabilities?

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Programmes, publications and events

Programmes

**Treasury programme**

With the ever increasing pace of change to regulation, compliance and technology, treasury has increasingly become a strategic business partner across all areas of the business, adding value to the operating divisions of the company. EY’s aim is to support and connect with Treasurers as their role continues to evolve.

Email eytreasury@uk.ey.com to share your thoughts on hot topics you would like to see covered as we develop our programme of events and communications throughout the year.

**Finance Professionals’ programme**

Recent years have seen greater challenges for finance teams. The Finance Professionals’ Programme is designed to give clients the opportunity to debate and discuss the latest emerging trends and issues affecting their business and role. It covers the broader business agenda, current issues in accounting and regulation, and career development. To sign up for our bulletin and receive invitations to events email fpprogramme@uk.ey.com
Publications

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Our Capital Agenda blog provides you with a topical and timely perspective on the latest financial market news and analysis and how this might affect your Capital Agenda. Read the latest posts at capitalagendablog.ey.com.

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Our weekly bank and capital markets update provides the latest insights, trends and issuance information. Visit www.ey.com/uk/cdainsights to sign up to receive this weekly newsletter.

**Credit Markets**

Credit markets discusses the issues which have affected the credit markets and gives a view on the year ahead and what 2015 might bring for businesses as they navigate the debt markets and capital providers. Download your copy at www.ey.com/uk/cdainsights.
Business Resilience

The business world has changed. Markets are highly uncertain, and the future difficult to predict, with numerous issues facing businesses. Business Resilience is the ability to identify, mitigate and adapt to these issues and seize the opportunities they present. Our unique approach helps companies consider their resilience across four key areas recognised as being vital to protecting and enhancing any organisation. Find out more here: www.ey.com/uk/businessresilience.

EY Item club

EY have been sole sponsors of the ITEM Club for 25 years. It is the only non-governmental forecasting group to use HM Treasury's model of the UK economy. Our reports provide a detailed economic analysis and forecast of economic activity for the period ahead. They are independent of any political, economic or business bias.

Mark Gregory, Our Chief Economist, provides the business implications of these macro-economic forecasts. To view the latest update visit www.ey.com/uk/item.
Events and webcasts

IFRS 9: reviewing your approach to risk management

Our recent webcast on the new accounting standard IFRS 9 is now available on demand at www.ey.com/uk/futureofukgaap. The International Accounting Standards Board (IASB) issued the final version of IFRS 9 Financial Instruments on 24 July 2014. IFRS 9 brings together the classification and measurement, impairment and hedge accounting phases of the IASB’s project to replace IAS 39 Financial Instruments: Recognition and Measurement and is expected to be effective for annual periods beginning on or after 1 January 2018.

Financial Reporting Outlook 2015

The annual Financial Reporting Outlook conference is one of EY’s flagship events. It has been running for over a decade, attracting senior business and finance leaders from more than 200 major companies each year.

The Financial Reporting Outlook focuses on the key financial reporting changes and regulatory challenges ahead, providing the opportunity for leaders to prepare for these. Every year our delegates hear directly from leading international regulators on their perspective of the most significant issues for the coming year. We recognise that clients are impacted not only by regulatory change, but also by broader economic and commercial matters, so our speakers also include key business figures. To register visit www.ey.com/fro.
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