Risk!

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In the April Risk

Risk this month offers a two-tier hedging strategy from Dan Perkins, CTP, a member of the Editorial Advisory Board. There's also advice on dealing with vendors: Karen McIsaac writes about vendor risk management, then your peers discuss vendor debit payments. And corporate practitioner and AFP Treasury Management Forum presenter Lorraine Weber, CTP, tackles counterparty credit risk

When is a Ratings Change Not a Ratings Change?

Brian Kalish, Director, Finance Practice for AFP

Answer: It is not a ratings change when an entire asset class has its rating methodology recalibrated. That is what will happen to the U.S. municipal bond market starting in mid-April, when Moody's will recalibrate its long-term U.S. municipal bond ratings to its global rating scale (GRS). The transition period is expected to last four weeks.

Previously, Moody's maintained a separate ratings scale for municipalities. The focus of the municipal scale was on the relative strength of credits within the municipal universe only, and the distance to distress for those credits. Going forward, the GRS will emphasize expected loss, which includes both probability of default and loss.

After the transition to the GRS, Moody's no longer will maintain a separate municipal scale. The goal of moving to a single scale is to increase the degree of comparability of all credit ratings. In the past, it has been difficult to compare non-municipal ratings such as corporates and sovereign governments to U.S. munis.

The net result of this transition will be a ratings uplift for most state and local government long-term ratings by up to three notches. The degree of the uplift will vary depending on the particular sector of muni market and the individual credit involved. Moody's is not making changes to short-term muni ratings since those short-term ratings had previously been based upon other global sectors.

Moody's is going to particular pains to emphasize that these changes are not ratings upgrades, but rather changes due to moving to a new scale, namely the GRS. Going forward, after the transition period, all changes to a particular credit will be solely a function of that particular credit.

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Taming Commodity Risk

Dan Perkins, CTP

Companies hedging commodity risk traditionally rely on procurement strategies such as fixed-price contracts, escalation clauses, and inventory stockpiling to minimize the risk of price escalation. But with today's volatile commodity pricing, procurement measures alone often are not enough.

What is the solution? Companies with exposure to commodity price fluctuations can manage commodity risk with a two-tier hedging program. The first tier utilizes operational, or supply-side, hedging strategies. The second tier uses hedging strategies employing financial instruments such as derivatives to more fully cover risk exposure. Operational and financial hedging strategies can be used in tandem to mitigate financial reporting and secure investor confidence.

Before using derivatives, executive management should design a hedging policy to control derivatives usage. The policy should identify the person(s) responsible for managing the hedge program, particularly derivatives; define commodity risk tolerance levels that might trigger derivatives usage; and name acceptable financial tools and techniques. Policy guidelines should direct derivatives managers to use

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Part of the thought process behind making this transition was to better align credits with similar historical default rates. Historically, munis have experienced very low default rates. It is important to keep in mind that even though the default rates may be similar within particular GRS category, the factors that influence potential default are very diverse.

The four major muni market sectors moving to the GRS are:

- State Governments
- Local Governments
- Enterprise Sectors
- Housing and State Revolving Funds

To the degree a particular sector already was rated on a global scale, the amount of uplift will be limited. The more similar the analysis, the less the impact.

This recalibration should make it easier for corporate treasury to understand the creditworthiness across the taxable/tax-exempt divide. ▲

News

Congress Updates Cybersecurity Proposal

Michael Griffith

Senate Commerce Committee Chairman Jay Rockefeller (D-WV) and Sen. Olympia Snowe (R-ME) recently released an updated version of their Cybersecurity Act (S. 773). The original bill was introduced in April 2009, and the update is intended to address a number of criticisms the original effort received.

The original bill would have greatly expanded executive powers, with a very controversial clause allowing the President to shut down or take control of parts of the country's data infrastructure in the event of a catastrophic attack.

The revised bill focuses on public-private collaboration, leading to intelligence sharing, improved voluntary standards, increased funding for research, and increased policy reviews. The bill maintains its call for a National Cybersecurity Advisor, who would coordinate national policy, report directly to the President, and face Senate confirmation.

The revised bill would also require the President to conduct a review of cybersecurity policy to define critical infrastructure, collaborate with industry and interest groups, and develop, implement, and rehearse an emergency response policy.

The Commerce Committee held a hearing on the new language on March 24.

Despite the renewed attention in cybersecurity, gridlock continues as the Senate Homeland Security Committee seeks to maintain its jurisdiction on the issue. The committee's chairman, Sen. Joseph Lieberman (I-CT), promises legislation in the next "several weeks." Chairman Lieberman has asserted national cybersecurity policy should be the Department of Homeland Security's (DHS) responsibility and that the Commerce Committee proposal would dilute DHS's authority.

AFP has long advocated for national data security standards for payments systems to provide both security and legal certainty in the event of a breach. Initial meetings with Commerce Committee staff led to indications that they consider the PCI standard to be sufficient. AFP members, on the other hand, argue that the PCI standard offers insufficient protection and no legal certainty for companies that undergo costly compliance efforts.

AFP will continue to monitor this issue and provide formal comments when necessary.

Michael Griffith is Legislative Analyst for AFP.

Risk!

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Taming Commodity Risk *continued from page 1*

simple instruments until the manager's skill level matches the complexity of the derivative.

Assign responsibility

First, a company's top executives must assign to a hedging manager(s) clear responsibility for managing commodity risk and coordinating strategy across the company. Who plays this role differs among companies. Where responsibility should lie is a function of a number of factors specific to a company, including:

- Is the treasury group familiar with the use of derivatives for foreign currency and interest rates already? Can this knowledge be transferred to the purchase of food, metals and energy commodities?
- How substantial is the commodity risk to the gross margin of the division or the entire company?
- How widespread is the knowledge of derivatives at the company? What has been the historic experience of the company using these hedging instruments?

A multi-disciplined, coordinated risk management committee with oversight by senior management, strict policies, controls, frequent counterparty credit risk assessments, and reporting usually leads to a successful hedging program.

The hedging manager must identify line items in the company's financial statements that could vary based on price fluctuations both with today's raw material supply order, and with supply orders up to 18 months into the future.

That risk is then measured against budget. The hedging manager determines the notional value of risk by assuming the company would be able to buy a commodity, like corn, next year at today's prices. He or she compares that notional value to historical price volatility and forecasts to measure the size of risk. For example, if the price of natural gas moves 50 percent, 25 percent or just 5 percent in the next 12 to 18 months, hedging managers can determine how those price changes might affect financial statements.

Based on potential price movement, the hedging manager can then decide whether the company can tolerate that risk or if the company would be better off managing that risk. For example, the airline industry typically cannot tolerate big price surges in fuel prices because so much of their cost structure is tied up in fuel.

The hedging manager must select an appropriate, supply-side hedging technique to pursue, such as a fixed-rate contract with suppliers; a defined escalation clause or a risk sharing agreement; or inventory stockpiling to use or resell if prices escalate. If a company can negotiate a 12-month agreement to fix its costs or selling prices, or it can have a reasonable escalation clause that shares risk with its customer or supplier, using an operational approach might be easier to manage than hedging daily derivatives.

When supply-side hedging techniques do not sufficiently align commodity risk with corporate tolerance levels, financial hedging techniques must be selected. For a company that has significant energy risk where its supplier can provide fixed prices for only 30 days or will not provide fixed prices at all, the futures or forward market can provide a liquid hedge of this risk for a reasonable cost for up to18 months.

Companies are required to update forecasts against the notional value of the underlying instrument and account for ineffective hedges. Most companies report mismatched hedges at least quarterly. For large companies, sophisticated modeling is used to support daily hedging activities and reporting. Modeling might be more onerous for middle-market and smaller companies, especially when derivatives hedging is undertaken only once a week or once a month. ▲

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A longer version of this article was printed in www.AFPonline.org/Exchange

Your Colleagues Discuss Vendor Debit Payments

Ira Apfel

Recently on AFP's discussion board corporate treasury and finance professionals discussed vendor debit payments:

Does anyone permit vendors to debit payment out of your company bank accounts? To what extent? What are the issues? We do not currently but the question has arisen. Thanks for any input.
—Brenda S. Szymanowski, CTP, Treasurer, AstenJohnson, Inc.

We only allow authorized vendors to originate debits on our accounts. Our tax work is done in house and the payments are made through the respective state's Website. We also have some time sensitive payments related to the releasing of freight where our AP supervisor is allowed to pay these charges from the Voyager Port Website.

We did run into a problem with employees using the Voyager Website to make payments so we implemented a total ACH debit block on our cash disbursement account. Nobody outside a small group would know what account and ABA to use to make those payments now and this obviously solved that problem.

We also monitor our back accounts daily and have had no fraud issues with vendor originated payments. It has proven a useful tool but is still only used in small doses.
—Steven Tanyko, CTP, Treasury Analyst, Phoenix Int'l Freight Services, Ltd.

Our basic policy is no. However, there are a few state tax authorities that make any other payment method so onerous that we have set up one account with a debit filter and only fund it when we know the amount and payment date.

Most financial institutions have ACH blocks and filters and/or ACH positive pay where you can block and filter out the specific vendors you want to allow access to debiting your bank account. ACH positive pay is in real-time where you get a notification asking you to decision online whether you want to allow that particular vendor to debit your account. If they are a valid vendor and you are okay with them debiting your account, you could then add them immediately to your approved listing online so that in the future they will not be a "decisioned" transaction. Your account would then be debited as well for that transaction.

ACH blocks and filters is the less expensive and more manual way (i.e. paper flow) for companies to mitigate ACH debit fraud. It is not in real-time and cannot be "decisioned" immediately as you can with ACH positive pay but can be just as effective in blocking and filtering out ACH debits. With ACH debit fraud being a significant liability for banks and corporations, mitigating these with a block and filter solution is critical.
—Jeff S. Reamer, CTP, VP, Global Treasury Sales Officer, Bank of America Merrill Lynch

Our basic policy is no. However, there are a few state tax authorities that make any other payment method so onerous that we have set up one account with a debit filter and only fund it when we know the amount and payment date.
—Anonymous ▲

Counterparty Credit Risk

Ira Apfel

According to AFP research, counterparty credit risk remains a key concern for corporate treasury and risk professionals. Risk recently asked corporate practitioner **Lorraine Weber, CTP, Treasury Manager for outdoor equipment retailer REI**, for her insights.

Risk: How can corporate treasury and finance professionals effectively mitigate counterparty risk given the current lack of credibility of public ratings?

Weber: For our investment portfolio, specifically our money funds, we're finding that being able to have a conversation with the portfolio managers is crucial during significant economic events. Having those relationships through our account managers means we can quickly gauge exposure to counterparties in the portfolio, or dig deeper into asset classes such as ABS or SIVs. It's just not enough anymore to know your fund is AAA rated. We need to be able to report to senior management that the underlying strategy and securities in the fund are sound and consistent with our investment policy.

Risk: What best practices/ideas/success stories can you offer to help AFP members implement and better monitor credit-worthiness and manage relationships with financial counterparties and in the supply chain?

Weber: Regarding counterparty risk in our supply chain, REI has developed strong cross-divisional relationships within our organization to help identify and evaluate risks as economic conditions with our partners change. For instance, if a vendor comes to Accounts Payable asking for early payment for a particular invoice, AP will involve treasury for a cash flow and cost of funds analysis, and we'll bring in our merchandising group to help assess the financial health of the vendor—occasionally asking to see financial statements, and determining if the early payment request is indicative of a larger cash or credit issue with that vendor.

Weber will speak about counterparty credit risk at the inaugural [AFP Treasury Management Forum](), April 21-23, in Washington, DC. ▲

AFP Treasury Management Forum: Time Well Spent

Busy corporate treasury and finance professionals may find it hard to get out of the office for a conference these days, but one event that is definitely worth the trip is the **AFP Treasury Management Forum,** April 21-23, in Washington, DC.

Take a look at the companies speaking at the Forum:

- AOL
- Bank of America Merrill Lynch
- BNY Mellon
- Citi
- Coca Cola Enterprises
- Costco
- Custom House, a Western Union Company
- Ford Motors
- General Mills
- Industrial and Commercial Bank of China
- J.P. Morgan
- McCormick
- REI
- SWIFT
- Towers Watson
- U.S. Bank
- USPS
- Zappos.com

Senior executives from these companies will cover your most important treasury concerns:

- Working Capital
- Risk Management
- Technology
- Globalization

Plus, two Members of the House Financial Services Committee have confirmed to speak as well:

- *Rep. Jim Himes, D-Conn.* Worked at Goldman Sachs for 12 years, rising to Vice President. Worked extensively in Latin America and headed its telecommunications technology group.
- *Rep. Gary Peters, D-Mich.* Vice President of investments for Paine Webber from 1989-2003. Before that, he was with Merrill Lynch.

The AFP Treasury Management Forum also is approved for CTP recertification credits and CEP credits. Register now!

Senate Banking Committee Approves Financial Regulatory Overhaul

Michael Griffith

That was quick.

The Senate Banking Committee recently approved the Restoring American Financial Stability Act of 2010 after less than 20 minutes of debate. The bill is a slightly modified version of a recently released draft authored by Committee Chairman Christopher Dodd (D-CT). Sen. Dodd's bill would create a Financial Stability Oversight Council composed of current federal regulators to monitor systemic risk, and empower the FDIC to wind down systemically risky firms in the event of a collapse. The bill also included a provision similar to the "Volker Rule" introduced by President Obama earlier this year that would prevent depository institutions from owning hedge funds and private equity firms and engaging in proprietary trading.

No news on derivatives

The bill includes a derivatives provision from an earlier proposal that was widely panned by both Democrats and Republicans. In introducing his draft, Sen. Dodd indicated the derivatives title was a placeholder for a bipartisan effort authored by Sens. Jack Reed (D-RI) and Judd Gregg (R-NH). The senators were unable to reach a deal in time for the mark-up and it is unclear what their proposal contains.

As it stands now, the derivatives title of the bill would require end-users to clear any swaps accepted by a clearing house, unless regulators issue rules to exempt specific trades or groups of end-users. If either party wishes to require clearing on a derivative transaction, the trade would have to be submitted. Some have expressed concern that dealer-brokers may expand into clearing and require unnecessary clearing.

Further, the proposal would give regulators the power to proscribe margin requirements. Also, both counterparties to a trade would have to report to a swap repository or the appropriate regulator.

Sen. Dodd's draft incorporated a number of non-controversial and technical amendments from fellow Democrats in a Manager's Amendment. After brief opening statements from Chairman Dodd and Ranking Member Richard Shelby (R-AL), the bill was brought to a vote without entertaining any additional amendments.

The Senate Banking Committee then approved the measure along party lines, 13-10, in less than 20 minutes. Sens. Dodd and Shelby pledged to continue to work on the bill and amend it on the floor of the Senate.

It is unclear what the prospects for the bill or its incomplete derivatives title are at this time.

AFP will continue to advocate for an end-user exemption to possible margin and capital requirements and mandatory clearing. AFP also will advocate for the adoption of a number of proposed amendments that would increase transparency, competition, and accountability for credit rating agencies. ▲

Michael Griffith is Legislative Analyst for AFP.

New IRS Reporting Requirements for 'Risky' Tax Positions

Philip R. West and Amanda Pedvin Varma

The IRS has announced plans to implement a significant new initiative to require certain business taxpayers to disclose information regarding "uncertain" (in other words, "risky") tax positions. The new IRS initiative, which is detailed in IRS Announcement 2010-9, will require business taxpayers to disclose to the IRS their most sensitive and tax positions and devote significant additional resources to evaluating their tax positions and preparing tax return filings.

Businesses with total assets of $10 million or more will be required to report to the IRS details regarding uncertain tax positions for which they must establish reserves for financial statement purposes.

What it means

Businesses with total assets of $10 million or more will be required to report to the IRS details regarding uncertain tax positions for which they must establish reserves for financial statement purposes.

An uncertain tax position would include a position for which a tax reserve must be established under FIN 48 or other accounting standard, or any position relating to the determination of U.S. tax liability for which the taxpayer or a related entity has not recorded a reserve because the taxpayer expects to litigate the position or because the taxpayer has determined that the service has a general administrative practice not to examine the position.

Under FIN 48, a business issuing financial statements under GAAP must evaluate each of its tax positions for whether the position is likely to be sustained on its technical merits. If a position is not likely of being sustained, the business must record a full reserve for that position.

In other words, if a position does not have a better-than-50 percent chance of being sustained, the business must assume it will not be sustained. If a position meets the "more likely than not" threshold, the business taking the position must determine how much of a reserve to place against the tax benefits it is claiming on its tax return for that position. In sum, the business may record the largest benefit that has a greater than 50 percent chance of succeeding and must establish reserves for the balance.

Implementing the initiative

To implement its new initiative, the IRS is developing a schedule that affected business taxpayers would be required to file with their tax returns. The schedule will require:

- a concise description of each uncertain tax position, the rationale for such position, and a general statement of the reasons for determining that the position in uncertain
- the maximum amount of potential federal tax liability attributable to each uncertain tax position.

To be considered sufficient, the description will require:

- the Internal Revenue Code sections potentially implicated by the position
- the taxable year, or years, to which the position relates
- a statement that the position involves an item of income, gain, loss, deduction, or credit against tax
- a statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both
- a statement whether the position involves a determination of the value of any property or right
- a statement whether the position involves a computation of basis.

The IRS said in Announcement 2010-17 that it plans to release a draft schedule and instructions in early April 2010. It plans to require the filing of the new schedule for returns relating to the calendar year 2010 and for fiscal years that begin in 2010, but not for 2009 tax returns filed in 2010. The IRS is evaluating options for penalties or sanctions that could be imposed if a taxpayer fails to make adequate disclosure of the required information.

Significantly, the IRS will not require businesses to disclose the perceived strength or weakness of their positions or the specific amounts that they reserved for each position. Taxpayers have, however, expressed concerns that disclosing even the limited information required by the announcement may cause them to waive inadvertently certain protective doctrines, such as the work product doctrine.

According to Announcement 2010-9, the new policy does not affect the IRS's "policy of restraint" in requesting tax accrual work papers, which generally constitutes documentation of a company's analysis of tax contingencies and the reserves it reports on its financial statements, including the amount of the risk and the amount of the reserve for that particular item. The IRS's current policy is to request tax accrual work papers from taxpayers that engage in transactions that are "listed" by the IRS as tax avoidance transactions.

Public comments are open until June 1, 2010. ▲

West is a partner in the Washington office of Steptoe & Johnson LLP. Varma is an associate in the Washington office of Steptoe & Johnson LLP.

Vendor Risk Management

Karen McIsaac, PMP

- **Item:** A local government disclosed that over $6 million had been spent on a program for the judicial and criminal justice systems, but nothing had been delivered. The program was ultimately cancelled.
- **Item:** A publicly traded company announced to shareholders and the public that the last quarter dividends would be reduced $.30 to $.40 per share due to "problems" with the poor execution and deployment of anew Enterprise Resource Planning system.

What do both of these real-world examples have in common? Both were negatively impacted by misspent project funds. These examples demonstrate significant investments that required managing an outside software vendor. Many organizations turn these types of initiatives over to the vendor only for the project to falter or fail.

The root cause of all these problems is poor execution of program/project management—of which vendor management is just one component. Mature organizations avoid pitfalls by executing projects using defined success measurements, business-based governance, and oversight of these dollar investments.

When a change initiative requires a large overall investment and has a big business impact, it does not make sense to turn the organization's success over to a vendor with conflicting priorities. The vendor goes away at the end of the engagement, but the organization must live with the results, good or bad.

Another risk is when an operational manager with other responsibilities is brought in to oversee a business transformation initiative. I refer to these individuals as "accidental" project managers. The accidental project manager generally is someone that does not possess the skills or experience to drive a program or project.

What can happen to projects led by accidental project managers who are not trained to manage large initiatives involving outside vendors? Consider the government agency installing the ERP. The accidental project manager recognized at a very late date that the vendor was incompetent and not performing up to expectations. The vendor subsequently was dismissed and then proceeded to take the government agency to court. Because the contract and vendor performance had not been managed, tracked and clearly documented, the vendor left with an additional $3 million in its pocket for non-performance of the contract.

Documentation is key

Documentation ensures that the project has appropriate controls, transparency and deadlines. These controls and documentation can be leveraged in the event that legal issues surface. Project sponsors and stakeholders do not want surprises regarding vendor communication of status, deliverables and releases.

Other examples of documentation include:

- **A fully integrated work plan** that includes vendor and client deliverables and activities
- **Clear statement of work for vendor activities**—level-setting expectations in writing
- **Clear, reported metrics regarding service level agreements**—they are indicative of vendor performance
- **Quantifiable metrics that represent current and future state associated costs**. This is called Earned Value—if the vendor has invoiced 70 percent of the contract and completed 10 percent of the work there is a gap.

- **Formal processes for managing changes**. These changes may represent management of cost, timelines, risks, quality and lastly, knowing if the change has impacted someone else)

Smart project management professionals also:

- **Ensure that the vendor has appropriate processes** in place to support quality requirements
- **Possess a structured method to review** and client acceptance of deliverables, release control, incident tracking and revalidation
- **Manage vendor and client contracts** and performance
- **Collaborate with client procurement/ sourcing partners** for contract questions/performance indicators
- **Ensure there is performing vendor software in escrow** that has been accepted by the client and outlined in contracts
- **Transition vendor knowledge** to client resources prior to vendor exit. ▲

Karen McIsaac, PMP, has over 20 years experience in delivering large business-driven initiatives. She presented at AFP's 2009 Annual Conference and hosted a Webinar for AFP members. Reach her at 704.332.6611 or visit www.projectmgrs.com.

The full version of this article is at www.AFPonline.org/Exchange.