Risk Accounting and Economic Profit

As the evolving risk landscape in which enterprises operate becomes more complex, management accounting must also evolve to incorporate risk.

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If CFOs were to be asked what keeps them awake at night, their answer is likely to be "unexpected losses." There can be no worse experience for a CFO than to have to explain to the CEO, the board, the media and, in extreme cases, in congressional or similar governmental hearings, why he or she only first became aware of the accumulation of excessive exposures to risk after those exposures had turned into losses.The concern is evidently genuine given the numerous instances in the recent past of CFOs being confronted with precisely these circumstances.

Such concern should alert accountants to the possibility that their accounting standards and reporting practices may not have kept pace with the quite dramatic changes that have occurred in the risk landscape in which modern businesses operate.

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In a little less than a generation. supply chain, cyber, financial, and other risks have grown exponentially, driven by phenomenal advances in technology and science; increases in the complexity and sophistication of financial products; greater operating dependencies on globally interconnected data and information networks; and heightened geopolitical uncertainties.

Nevertheless, prevailing accounting standards, such as IFRS and U.S. GAAP, have remained largely insensitive to these changes in that accounting profit and financial condition reported in financial statements are not intended to consider the likely economic effects of accumulating exposures to risk. Some CFOs have responded by promoting "economic profit" as a primary financial performance metric given its risk-adjusted properties. There are a number of definitions of economic profit but, in principle, it is accounting profit less a capital charge to represent the opportunity costs associated with revenue generation. It is typically applied to the capital consumed by business lines at the respective firm's required rate of return on capital, or "hurdle rate."

OPINION

The arguments in support of migrating to economic profit are compelling provided it is accepted that a core function of capital is to act as a buffer against unexpected losses. This is particularly the case where prudent enterprises build deep capital reserves well in excess of their basic operating needs to compensate for their limited ability to observe and manage accumulating exposures to risk. It follows that imposing capital charges on business

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lines according to the capital they consume would better align performance reporting with modern realities. But this presupposes that the risk exposures business line managers accept in order to create shareholder value can be reasonably and consistently identified and quantified. If that were possible, a major role for management accountants would emerge aimed at institutionalizing economic profit as the primary performance metric.

If they were able to go one step further and apply such a capital charge to each business line's marketed products and services, then a comprehensive and effective enterprise risk management (ERM) system could be the outcome. The resulting management accounting system would oblige business lines to price their products and services after accounting for a risk-based capital charge that would also be charged to their respective P&Ls, thereby creating an in-built incentive to mitigate risk based on economic profit.

There is a potentially compelling logic here if it is accepted that exposure to risk is ultimately transferred to consumers through defective or mispriced products and services. If we examine the extreme unexpected losses suffered by enterprises in the recent past — the so-called "fat tails" or "black swans" — they are invariably associated with failures related to defective or mispriced products and services. That was certainly the case with the large-scale, unexpected losses experienced by financial institutions through the financial crisis of 2007-2008 that were mainly attributed to defects in, and the mispricing, of subprime mortgage products.

Techniques that assign costs to individual products and services have already been refined by management accountants. One such technique is Activity Based Costing (ABC). ABC identifies the activities involved in the manufacture of products and services, calculates the cost of such activities, and assigns the resulting costs according to actual activity consumption. The "fully loaded" cost of production provides the basis on which products and services can be competitively priced. If ABC were extended to incorporate the cost of capital, operating management would be incentivized to achieve improvements in both operating efficiency and risk mitigation that would, in turn, lead to improved economic profits and more competitive pricing of products and services. An improved foundation for the more effective management of capital would also be provided.

In my previous article for CFO.com, Welcome to Risk Accounting, I commented on an ongoing academic endeavor to codify a common risk exposure quantification and reporting framework similar to ABC in its overall intent and design. The article provides an overview of the risk accounting method and a more detailed description is available in a research working paper that has since been published in the Journal of Risk Management in Financial Institutions. Whereas the theoretical models and concrete examples included in the paper relate to banking, the method can be adapted for non-banks.

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