

# The Global Risk Regime: New Roles for Auditors

With Sarbanes-Oxley as a precedent, accountants and auditors can take on increasing responsibilities as trusted third parties

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In the aftermath of the financial crisis, the G20's Financial Stability Board invited auditors to play a more prominent role in assisting the FSB in its mandate to stabilize the global economy. Also, the Basel Committee on Banking Supervision issued new requirements primarily aimed at ensuring the accuracy of banks' risk data by requiring its reconciliation to a bank's accounting data. A series of subsequent regulatory initiatives involve auditors directly, or that point to involving them further, in the global regulatory regimes overseen by the FSB and the BCBS.

These regulatory developments draw comparisons to the U.S. Sarbanes-Oxley Act (SOX) and similar legislation enacted globally with the aim of reducing the risk of material misstatements in financial reporting.

This article considers whether the role and responsibilities of auditors framed in SOX should be extended to risk reporting, and whether accountants and auditors should participate in adjusting the financial metrics of risk to conform to the evidence of the financial crisis. That is that risk exposures were accumulating in financial institutions and were not detectable in audited financial statements. This represents both a risk quantification challenge and an accounting challenge. Accountants and auditors are

being challenged by regulators to participate more fully in risk adjusting the financial system.

### **Basel Committee Prescriptions**

Accounting firms, as a group, are the most knowledgeable and intimate external partners of client companies, offering services ranging from audits to management consulting, from risk and compliance reviews to third-party assurance services. They are called upon by governments and courts, by corporations and individuals, and by regulators to be fair-minded, objective analyzers of facts and arbitrators of contentious issues. Auditors have been involved in discussions on global risk issues since the financial crisis.

Their roles and responsibilities have increased in line with heightened regulatory demands requiring independent assurance of compliance. The expectation is that the activities of audit firms in this regard will increase further to ensure that the risk data and risk reporting made available to regulators and other stakeholders are complete, accurate and timely.

In the aftermath of the financial crisis, the Basel Committee on Banking Supervision issued more prescriptive requirements relating to risk data aggregation and risk reporting, notably the 2013 document known as [BCBS 239](#). By becoming more prescriptive with respect to the internal controls and procedures that banks will be required to apply to their risk data and risk reporting, the BCBS seeks to reduce the probability and severity of losses resulting from data and risk management weaknesses, improve the speed at which risk reports are available, and improve each organization's ability to manage the risk of new products and services.

To accomplish this, among other requirements, the BCBS prescribes that controls over risk data be as robust as those applicable to accounting data. This includes the reconciliation of risk data to a bank's sources, including accounting data, to ensure

that the risk data is accurate and available in a single, authoritative source per each type of risk.

In addressing the infrastructure of banks in support of these goals, the BCBS said:

“One of the most significant lessons learned from the global financial crisis that began in 2007 was that banks’ information technology and data architectures were inadequate to support the broad management of financial risks. Many banks lacked the ability to aggregate risk exposures and identify concentrations quickly and accurately at the bank group level, across business lines and between legal entities. Some banks were unable to manage their risks properly because of weak risk data aggregation capabilities and risk reporting practices. This had severe consequences to the banks themselves and to the stability of the financial system as a whole.”



*Allan D. Grody*

### **Valuation versus Prediction**

These new requirements from the BCBS have parallels with the U.S. SOX law, enacted in 2002, and similar rules in Australia, Canada and Japan. SOX was a response to a series of such major corporate and accounting scandals as those of Enron and WorldCom. At the core of those scandals were material misstatements of information reported in audited financial statements that cost investors billions of dollars as the market values of the affected companies collapsed and confidence in the U.S. securities markets was severely impacted.

SOX’s section 404 requires companies to include in their published financial statements information on the scope and adequacy of the internal control structure and procedures for financial reporting and an assessment of the effectiveness of related internal controls and procedures. Independent external auditors, in that process, must

evaluate and report on management's assessment of its internal controls and procedures relating to published financial information.

Whereas SOX set out to address the issue of material misstatements of financial information in published financial statements, BCBS addresses the issue of material misstatements of risk information by banks. The fact that bank regulators are calling for SOX-like procedures in the banking sector relative to risk data and risk reporting suggests that there is scope for independent auditors to take on a more prominent role in the prevention of future financial crises. We are left to speculate on whether SOX-like regulations will be extended to risk reporting in the banking sector.

Already, to assure the proper implementation of the European Market Infrastructure Regulation (EMIR) in the EU, the German regulatory agency BaFin has taken a step to bring auditors into the equation. All financial market participants that use derivatives in Germany are facing stricter oversight of their reporting obligations due to the unique use of external auditors as an extension of regulatory supervision. This uniquely German approach, part of the *Emir-Ausführungsgesetz* (EMIR Implementation Act), has the force of law and breaches can incur upward of €500,000 in fines. EMIR audits are now being conducted in conjunction with annual financial statement audits.

### **Non-Financials Included**

The law requires auditors to validate EMIR procedures and for clients to pay for the service. All financial market participants that act as counterparties in derivatives trades will be subject to the new audits. Importantly, this includes non-financial companies with more than €100 million in notional outstandings in over-the-counter derivatives or 100 OTC contracts.

This is consistent with the FSB having previously asked auditors to help in carrying out the FSB's mandate to stabilize the global economy: "The FSB will continue to support dialogue between audit standards setters and regulators, investors, market regulators,

prudential authorities, financial institutions and audit firms on improving the quality of external audit and its contribution to financial stability.”

The German point of view is that the EMIR reporting process is material at the national level, so accountants, by law, are obligated to audit related processes and report any identified weaknesses directly to government agencies. In this regard, there is great interest in assuring the highest quality of data of individual legal-entity information for counterparties for swaps data reporting under EMIR and for aggregating risk data by such counterparties. This latter objective is to be accomplished through acquiring an FSB-initiated legal entity identifier (LEI) for each counterparty and aggregating through organizational hierarchies of parent control entities that are to follow accounting consolidation rules. LEI protocols require the at-source creator of the legal-entity data to initially self-register the data, certify it annually and update it as changes occur. A third party can be delegated for this activity, but the financial market participant remains responsible.

To date, this third-party delegation has been given over to local operating units (LOUs) as varied as data vendors, financial market utilities, government patent offices, national business registries, stock exchanges, central banks and national economic institutes. All are attempting to validate data from its originating source, the registrants' own input, but using multiple, secondary sources of electronic and manually produced public and private data, thus adding layers of potential errors of human interpretation and omission.

This validation process is potentially unsatisfactory for other reasons, as it requires LEI registrants to wait on a subsequent business registry validation or similar secondary validation sources. Financial market participants may have an immediate need for a LEI, for example, in order to trade upon the occurrence of a market event through a new business entity. They might want to time their LEI registration so that it coincides with the announcement of a merger; issue securities through a new business entity, etc. The World Bank has surveyed business formations in 91 countries and

concluded it takes on average 38 days to register a business, with the quickest at two days and the longest as much as 642 days.

### **Trusted Agents for Validation**

LEIs can be validated at source more simply and efficiently by relying on auditors as trusted agents to review the source documents. Among the most compelling reasons is to identify hierarchies of ownership. The LEI data elements of parent control entities (final beneficiaries) and organizational hierarchies are required by the FSB, which, initially, will follow accounting consolidation rules.

Auditors and their third-party assurance services can play a prominent role here. Using actual incorporation documents, prospectuses, trust agreements, applications to financial regulators, etc. that are routinely available to auditors, they can validate the details and, along with the self-registrant's own officer, enter the validated and 'certified' data into a LEI registry directly and immediately.

Finally, auditors need legal entity information to certify consolidated financial statements on an annual basis. This often requires an intense manual process to be conducted throughout the year, or at year end to track the ever changing corporate ownership and control hierarchies. Doing it once by auditors for multiple purposes, and having it electronically recorded in LEI registries, would suit all stakeholders' purposes. It ties the same business entity to both the audited books and records of the firm, to the same information in the risk databases, and to the same information used by financial institutions to extend credit, set trading limits and compute counterparty risk.

We believe self-registration augmented by auditor assurance, is how the LEI dataset and each LEI placement within its business ownership hierarchy should be accomplished.



*Peter J. Hughes*

## **Sarbanes-Oxley Parallels**

In the context of further aiding in risk management, accounting practices have been aimed at providing investors and other stakeholders with a static representation of an enterprise's financial condition. Thus, accounting has been more concerned with valuation than the prediction of the probability and severity of future losses that are likely to occur as market and macro-economic conditions change. This limits the usefulness of audited financial statements, as there is limited assurance that they incorporate the profit and loss implications of accumulating risks.

In recent years, the accounting profession has attempted to address this situation by recognizing, in accounting terms, the loss potential inherent in financial products. For example, fair market valuations price trading positions to market values (mark-to-market) and, more recently, positions are priced using financial models (mark-to-model).

Modern financial institutions now reflect the consequences of massive increases in concentrations of risk that changes their risk profile but do not necessarily trigger accounting events. Also, there continues to be no adequate accounting solution as far as the new contagion of systemic risk is concerned. Funding gaps, credit risk concentrations and correlations, unapproved trading positions, poor data, flawed models, the bypassing or overriding of controls . . . all are examples of risk conditions or events that do not necessarily translate into accounting events.

The financial crisis provided evidence that life-threatening exposures to risk were accumulating in financial institutions of all sizes. Such exposures defied identification and quantification and, consequently, were not reported in audited financial statements. This represents both a risk quantification challenge and an accounting challenge. They are inextricably linked.

## **Risk and Confidence Accounting**

Two new methods known to us are Risk Accounting, which we have proposed, and Confidence Accounting. Risk Accounting introduces a new metric, the Risk Unit (RU), to value risks inherent in financial transactions and applies the metric using a bottom-up transaction-based approach, allowing the risk system to be both aggregatable and tied directly to the accounting records of the firm. The RUs are also used to risk adjust the CAPM (capital asset pricing model) measure, thus tying risk accounting to management accounting.

Confidence Accounting may be understood as accounts using ranges. Much of the tension for accountants has been generated by single historic cost numbers colliding with the need for judgments about the future. More tension has been generated when historic and current accounts collide with future-looking risk scenarios. The premise of Confidence Accounting is that much of the tension is released when ranges are recognized as fundamental to any discussion about financial reporting.

Less boldly, various accounting standards bodies are attempting to make adjustments to historical costs, amortized costs and fair value accounting to be more sensitive to current and future risks. At the same time, regulatory bodies, principally the BCBS, are adjusting their risk regimes to reflect better measures of tail risk, such as substituting for Value-at-Risk the Expected Shortfall method for market risk; and providing an accounting-based leverage ratio to backstop the stochastic risk calculations.

### **Logical Auditor Roles**

There are many opportunities for auditors and accountants to step up to the task of assisting in risk-adjusting the financial system. Germany has taken the lead in formally using independent auditors to assist in the supervision of new regulatory risk mandates. The U.S. is suggesting a role for auditors in independence-testing of the Volcker rule. The FSB has described a trusted third party to be interposed in derivatives regulations, a natural extension of the auditors' trusted-third-party assurance role.

Providing assurance that risk data and accounting data are reconciled as called for in the BCBS risk data aggregation mandate is, again, a logical role for auditors. That the evolving global identification system is properly provided with high-quality data on ownership and control is, likewise, a natural extension of auditors' privileged need-to-know role and use of their functional skills in third-party assurance services.

In the financial crisis, exposures to risk were accumulating in financial institutions but not reflected in audited financial statements. Accountants and auditors are being challenged by regulators to participate more fully in stabilizing the global economy. Let's follow Germany's leadership in using auditors in the new swaps regime, and the U.S. and other countries in SOX-type compliance, to move the BCBS and FSB projects forward by involving accountants and auditors further in risk oversight.

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