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CFO challenge to accountants incorporate risk into accounting rules

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Stakeholders in public companies will be familiar with the form of independent public accountants' reports that communicate their opinion on published financial statements. In the USA such reports generally follow the lines:

> "*In our opinion, the (financial statements) present fairly, in all material respects, the financial position of (the company) in conformity with accounting principles generally accepted in the United States of America (US GAAP)"*

And a further example from the UK:

> "*In our opinion the financial statements give a true and fair view of the state of (the company's) affairs. (They) have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union"*

Independent accountants arrive at their opinions on whether a firm's financial position is 'fairly presented' or 'true and fair' by reference to nationally and internationally adopted accounting principles and standards such as US GAAP and IFRS. They are framed by standards setters to produce a static point-in-time statement of financial condition based, primarily, on the fair values of assets and liabilities that prevail at the time of reporting. Their opinions are not intended to consider the likely economic consequences of accepted risks should macroeconomic and other operating conditions change. In other words, they do not give assurance that a firm's risk profile is or is not endangering its financial position.

These accounting principles may have produced a relevant set of financial statements when risk concentrations within and between business enterprises were innocuous, but not today. Large-scale concentrations of risk are now a permanent feature of global business enterprises and the global financial system. This dramatic change in risk landscape occurred over a single generation of advances in technology and science; escalating business consolidations; increases in operating and product sophistication; an ever-growing dependency on interconnected data and information networks; and the advent of sophisticated risk intermediation products including the 'derivative', the 'synthetic' and the 'structured' product. It is questionable whether independent accountants can draw practiced judgments on a firm's financial position in a meaningful way if they do not also consider the risks firms must accept in order to create shareholder value in this highly competitive global business environment.

This evolving risk landscape obliges boards of directors and C-suite executives to become increasingly concerned with risk and its potential to trigger material unexpected losses. In the recent past there have been numerous examples of corporate disasters and financial crises involving unexpected losses on a scale that severely impacted or even wiped out firms' capital. It is not unrealistic to suggest that unexpected losses caused by the lack of effective identification, quantification and reporting of accepted risks are potentially more devastating to a business than accounting misstatements or deficiencies in internal controls that are today the focus of the opinions of independent accountants.

The absence of consideration of accepted risks in accounting principles causes disclosures of financial position based on such principles to be inherently favorable. Firms' management theoretically ameliorate the moral hazard inherent in overly favorable reporting of financial condition by including voluminous narrative disclosures on the status of firms' risk management. However, such disclosures typically follow boilerplate formats with content that is mimicked and replicated across whole industries. Their effect may be to mask actual risk exposures to investors and other readers of published financial statements thereby increasing, rather than reducing moral hazard.

The banking sector presents us with an excellent case study to illustrate these issues. It is often said that accountants are concerned with 'what is' and risk managers with 'what if'. Since the first capital accord issued in 1988, the banks' global regulatory standards setting body, the Basel Committee on Banking Supervision (BCBS), has focused on the 'what if' when determining the amount of capital banks should hold to buffer unexpected losses as a means to promote a secure banking sector.

In June 2004 the BCBS issued a revised capital accord 'Basel II' which, in principle, encouraged banks to adopt stochastic techniques rooted in advanced mathematics and physics, not in accounting. These techniques are used to calculate the amount of capital required to protect a bank in stressed operating conditions such as a severe recession. We can conclude from this that banks' financial statements had limited relevance for regulators as accounting based on fair values assumes normal operating conditions. Of greater concern to regulators was the likely impact on these fair values if an adverse condition, such as a severe recession, were to occur.

Banks of all sizes, including some of the world's largest banks, were found to be undercapitalised when the financial crisis of 2007/8 arrived. Banks failed in succession triggering government bailouts, forced acquisitions and bankruptcies. It culminated in the worst financial crisis since the Great Depression and brought the global economy to the brink of total meltdown.

It is self-evident that during the period leading up to the financial crisis massive exposures to risk had accumulated in banks and in the global financial system. The stochastic techniques promoted in Basel II that were meant to identify and quantify such risks were found wanting. Similarly, the accounting profession failed boards, CEOs, investors and other stakeholders due to accounting principles that were never intended to consider the likely economic impacts of accumulating risk concentrations. These financial statements, with their inherently favourable accounting, provided the basis on which banks misguidedly approved dividends, discretionary bonuses and share buy-backs only to become, months later, the object of government bailouts, forced acquisitions and even liquidations.

The sclerotic positioning of the accounting profession, whose accounting principles are rooted in a bygone era, is in stark contrast to legislators and regulators who, post crisis, reinvigorated its own outdated oversight principles. A veritable avalanche of new laws and regulations has been imposed on banks that practitioners estimate will cost as much as $50 billion to implement. Sovereign jurisdictions around the globe, through enacted legislation, have acquired powers to invoke their criminal justice systems against excessive risk-takers whose banks suffer unexpected losses associated with undisclosed risks. This repositioning by regulators and legislators appears at odds with that of independent accountants whose opinions on a bank's financial position are expressed without due consideration of accepted future risks.

The time has come when CFOs and CEOs who sign off on published financial statements should take the lead and challenge their accountants and the accounting profession to adapt accounting principles and standards to modern realities. A new accounting discipline is required... one that accounts for the risks inherent in approved transactions and the effectiveness of the enterprise to manage and mitigate those risks. We could term it 'risk accounting' a new generation accounting system to follow financial accounting and management accounting.

We've been here before. From the early-1980s, led by their CEOs, internationally active firms transformed their businesses as they migrated from legal entity and geographic based organisational structures to global lines of business. The signing-off on these firms' radically altered organization charts forced accountants to create a new accounting discipline – management accounting - to meet the new performance reporting requirements. Accountants very quickly learned how to tag transactions with the management information necessary to provide line of business reporting (organization codes, product codes, customer codes, etc.) and construct the tables that would drive the allocation of general ledger balances to newly-created reporting categories. In due course the accountants responded to a new business reality that transformed their extant legal entity and geographic based reporting infrastructures into a relevant business management and performance reporting tool.

Now CEOs are faced with yet another business reality driven by radical changes in the global risk landscape and one that CFOs and accountants have yet to respond to.

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For additional research on this topic click on **The Global Risk Regime - New Roles for Auditors** and **Risk Accounting** on the home page at www.FinancialinterGroup.com