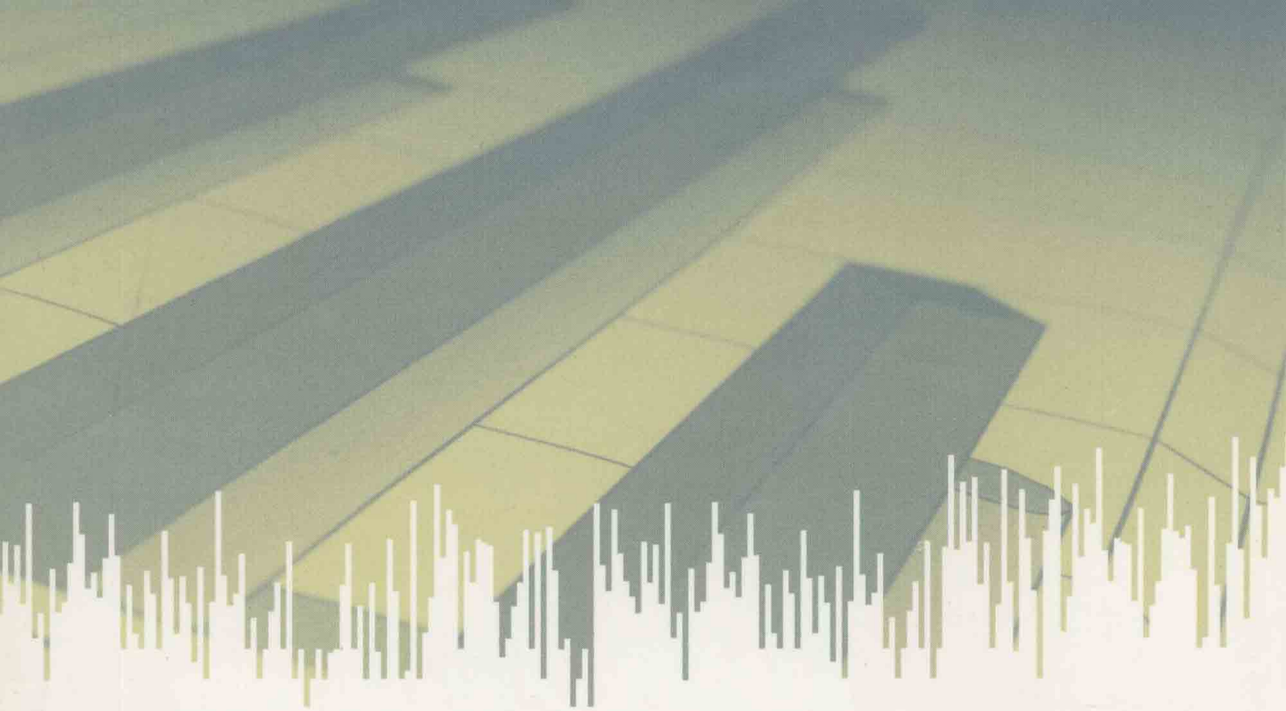

Reliable Financial Reporting and Internal Control

A Global Implementation Guide

DIMITRIS N. CHORAFAS

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Foreword

One of the great challenges facing the financial system is the risk inherent in increasingly complex financial instruments and strategies undertaken by increasingly complex financial organizations. Under normal circumstances, the sophistication of these instruments and strategies permits precise definition and pricing of risk, creating a wider ranger of financial products and spreading risk across a broader range of market participants to the benefit of all concerned. However, experience shows that even broad and deep international capital markets are susceptible to shocks and crises, to which even sophisticated financial intermediaries can fall victim.

In a crisis situation, the precise measurement and careful parsing of risks on which sophisticated financial strategies are premised can become irrelevant. Financial distress in an individual country or at a single financial intermediary can trigger losses that balloon and spread through the system. If the mechanisms by which this occurs are sometimes obscure, the implications for markets and market intermediaries in developed and emerging markets alike are clear enough. The 1987 stock market crash, the failure of Barings, the Asian crisis, the collapse of speculative investment in Russia, and the near collapse of LTCM suggest the variety of ways in which trouble may arise in international capital markets.

If shocks are inevitable, then it is essential that internationally active financial institutions and especially the large, sophisticated institutions that are the pillars of the international system are fortified against them. This has been a primary focus of concern for the Group of Thirty in the last 15 years, resulting in a series of recommendations for reducing clearance and settlement risks, strengthening risk management of derivatives, and promoting stronger management, greater transparency, and comprehensive supervision of the risks facing global firms. Since the Mexican crisis of 1994–1995, these issues have also become a central focus of international financial supervisors and a standard feature of G-7 Summit communiques.

The starting point for sound management of financial risks is the subject of this book: an effective system of internal controls established by the board of directors and management to provide feedback on the way the financial institution functions at all levels. As the author argues, this is not simply a matter of financial results but of command and control mechanisms, personnel management, and other performance characteristics of the firm. To be fully effective, controls must involve a range of techniques, supported by real-time monitoring, sophisticated computer systems and modeling techniques. Because all systems can malfunction and decay with time, internal controls must be regularly audited.

Professor Chorafas offers a comprehensive review of the issues involved in an effective control regime, including grand themes, key concepts, and detailed requirements, presenting them all in a very practical way. He has surveyed actual practice through extensive interviews and is not afraid to offer his best judgement about what makes sense. A particularly appealing feature of this analysis is that its basic approach is operational. Major institutions have been decomposing the risks they face and addressing them one by one, while supervisors have similarly taken a building block approach to risk-based capital requirements. Market and credit risks have been most thoroughly analyzed, while attention is only now focusing on operational and legal risks. This book argues that all risks should be evaluated in the context of performance failure.

The other appealing feature of the analysis is its broad, interdisciplinary approach. The analysis examines assessment techniques and measurement rules embodied in COSO, FASB, and the international accounting rules exercise. It examines how human and system errors are measured in other industries and contexts and suggests how they might be applied to financial services. In an industry with as many repetitive transactions as banking and as much data gathering on financial performance, it is interesting that quality control approaches and methodologies that have become commonplace in other industries have not been applied in this sector. Professor Chorafas may not have answers to all the questions that he raises, but he very usefully gets many of the questions on the table. In doing so, he provides an important public service.

JOHN WALSH
Director, Group of Thirty

Preface

Financial reporting is, fundamentally, a process of knowledge exchange. This process is, too often, simplistically equated with codifying information, feeding it into computers, shifting it around, and handling it through supposedly sophisticated models. In contrast, true knowledge integration is the outgrowth of financial, technical, and social processes—and, of course, of *internal controls* that assure the right thing happens at the right time. This is what underpins reliable financial reporting.

One of the main difficulties in global management of credit risk and market risk is that knowledge is often taken out of context. Something that is understood about counterparty exposure in one business environment may change meaning in another. Or, alternatively, the message may be wrongly interpreted, fail to arise management's sensitivity, or lead to absurd decisions.

Addressed to investment bankers, commercial bankers, institutional investors, treasurers, chief financial officers, company accountants, as well as certified public accountants, auditors, and financial analysts, this book brings under the same cover three crucial issues to the modern institution and the financial function at large: Internal control and international accounting standards; reliable financial reporting as defined by the Committee of Sponsoring Orginizations (COSO) of the Treadway Commission; and the New Capital Adequacy Framework by the Basle Committee on Banking Supervision.

Part One is dedicated to internal control concepts and processes, as well as to the controversy between International Accounting Standard (IAS) and the Generally Accepted Accounting Principles (GAAP). Accounting is the language companies speak among themselves and with regulators. A common accounting language is just as important as the establishment of a timely and accurate internal control system.

The subject of Chapter 1 is the board's accountability for internal control. After a brief review of the effects of globalization and consolidation on inventoried exposure, the text defines internal control, shows its synergy to risk management, examines formal and informal solutions to internal control challenges, and demonstrates the impact of transparency on management's ability to be in charge.

Chapters 2 and 3 address the issue of international accounting standards. They compare IAS to GAAP and, based on the results of my research, elaborate on the likelihood GAAP and IAS will merge into a global accounting system. This would be a great boost to global financial accounting reporting standards—assuring better understanding in capital markets and money markets, as well as in connection with derivative financial instruments. But its likelihood is not that high.

It is both legally and operationally necessary that financial conditions are correctly reported, but that is not enough. The reports must be done efficiently and effectively—two themes dominating this book. Peter Drucker defines *efficiency* as doing things the right way; and *effectiveness* as doing the right things. Efficient and effective operations are the second major requirement of COSO.

Part Two addresses efficient and effective operations. It reviews the work of the Treadway Commission and COSO, emphasizes behavioral controls, demonstrates the contribution quality control—and most particularly statistical quality control—brings to efficiency and effectiveness, and documents that many COSO guidelines have already filtered into Statements of Financial Accounting Standards by FASB.

Chapter 4 elaborates on the work that has been done by the Treadway Commission and the objectives that it targeted. This presentation starts with control environments, involves issues associated to fraudulent financial reports, emphasizes the critical role played by internal controls, and explains the benefits from implementation of COSO, whose first practical application took place at the Federal Reserve Banks of New York, Boston, and Chicago, in 1998.

Fraudulent financial reporting and its avoidance are the theme of Chapter 5. The Treadway Commission's guidelines for audit of financial reports are examined, focusing on the command and control system necessary to master an entity's financial operations. Chapter 6 emphasizes the importance of behavioral controls, drawing on the guidelines by COSO, COCO, and IOSCO as well as capitalizing on interdisciplinary cross-fertilization in behavioral studies.

Chapter 7 explains why a crucial subject in the assurance of reliable financial reporting is measuring and managing the quality of financial services. It covers the work of the Quality Control Inquiry Committee (QCIC) and the role of statistical investigation in quality assurance. Chapter 8 completes this presentation through practical examples on the use of statistical quality control (SQC) in banking. It discusses sampling plans and presents quality control charts by attributes, variables, and percent defective.

Analytical solutions work best when they are tuned to the observance of rules and regulations. For this reason, Chapter 9 concentrates on statements by the Financial Accounting Standards Board and associated reporting practices, including the assessment of hedge effectiveness. Chapter 10 addresses specifically SFAS 133, compares its clauses to SFAS 119 (which it replaces), and brings attention to the aftermath of the new regulation.

Part Three takes a close look into the issues which many experts consider to be the counterparties of reliable financial reporting—therefore, of COSO. These are capital adequacy and capital at risk. Quite often, creative accounting practices come into the picture because capital reserves are inadequate and/or more capital is put at risk than what the institution can afford under normal conditions.

The theme of Chapter 11 is the New Capital Adequacy Framework by the Basle Committee on Banking Supervision. This Framework is one of the best examples on the application of COSO's principles. In 1988, the Group of Ten central bankers, who form the Basle Committee, established the Capital Accord that addressed credit risk. In 1996, capital requirements were enriched with the Market Risk Amendment. In 1999, a new capital accord was drafted in a much more sophisticated way than the 1988 original.

Published in June 1999, the New Capital Adequacy Framework is still a discussion paper and there are many issues that will be debated before it becomes the new standard. Chapter 12 contributes to these issues by explaining the key factors that enter the redefinition of a bank's capital—specifically the role and use of internal ratings-based (IRB) models.

Following this process through, it leads us to capital at risk and earnings at risk, the issues of Chapter 13. The reader is first presented with the notions underlying a sophisticated application of capital at risk metrics and measurements. Then the discussion focuses on commitments whose impact is felt on current exposure, prudential limits, the volatility on capital at risk, and the need for literacy in high technology.

After having outlined the supervisory rules for greater transparency in financial reporting, including clauses still in the making, the text turns to those issues that present financial institutions with a somewhat greater freedom of choice. Market value accounting (Chapter 14) is an example, including issues such as fair value, present value, replacement value, and net replacement value.

Reliable financial reporting as well as efficiency and effectiveness in operations are not only regulatory issues. They are also the best way for financial institutions to look into the future, helping top management to identify what practices must stop. They also assist in projecting into the future some of the things senior management should be considering. The present is conditioned by the future, not by the past.

Never before has it been possible to look as far into the future as it is today, and with as much confidence about events to come. "Political ability," Winston Churchill once suggested, "is to foretell what is going to happen tomorrow, next week, next month, and next year. And to have the ability afterward to explain why it didn't happen."

DR. DIMITRIS N. CHORAFAS

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Contents