

Corporate Financial Risk Management: Governance and Disclosure Post IFRS 7

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So far, the new regulatory and accounting context of Corporate Financial Risk Management (CFRM) has deeply influenced the operations of corporates. New protagonists of the CFRM process have emerged rapidly. Accounting managers have been obliged to thoroughly understand the economics of derivatives, while the Board, the auditors and external financial analysts have become more deeply involved in the process of CFRM. Unfortunately, this revolution has not been accompanied by an adequate change in the language of CFRM, which is actually very complex and inadequate for both the Board and the analysts. Only the language of value creation can help in overcoming these problems, as it would allow the Board to improve the governance of the process of CFRM, and consequently, to communicate what analysts really need, through proper risk disclosure. From January 2007, IFRS 7 has introduced a new approach to risk disclosure. This is a good opportunity to design a reporting system, which exploits the language of value creation. This paper describes the main aspects of the new regulatory context of CFRM and explores some revolutionary improvements brought about by IFRS 7. It also gives some guidelines to the creation of a language that is apt for the governance and the disclosure of CFRM.

Introduction

Corporate Financial Risk Management (CFRM) concerns the management of financial price risks in corporates, namely interest rates, exchange rates and the prices of commodities. Since its first implementation in the 1980s, CFRM has evolved in three main steps. Firstly, the banks designed new structured products, exploiting their deep knowledge of financial engineering. Secondly, practitioners developed best practices concerning the correct use of derivatives in corporates, focusing on the organization and the reporting of the CFRM process. The third step is now underway and concerns the regulatory and accounting context of CFRM.¹

So far, the new context has deeply influenced the operations of corporates. The first evident impact concerns the less frequent use of complicated structured derivative products. Moreover, new protagonists of the CFRM process have emerged rapidly. Accounting managers have been obliged to thoroughly understand the economics of derivatives, while the Board, the auditors and external financial analysts have become more deeply involved in the process of CFRM.

Unfortunately, this revolution has not been accompanied by an adequate change in the language of CFRM, which is actually too complex for both the Board and the

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¹ For a detailed description of the new context of CFRM see Triana (2006), Section IV.

external analysts. The Board is not in a position to guide and control the process of CFRM, while the external analysts do not have the necessary information to understand if CFRM has an impact on the quality of earnings and on the creation of corporate value.

Only the language of value creation can help in overcoming these problems. Such a language would allow the Board to improve the governance of the process of CFRM, and consequently, to communicate what analysts really need, through proper risk disclosure. From January 2007, IFRS 7 has introduced a new approach to risk disclosure. This is a good opportunity to design a reporting system which exploits the language of value creation.

The next section of this paper describes the main aspects of the new regulatory context of CFRM. The following sections explore some revolutionary improvements brought about by IFRS 7 and give some guidelines to the creation of a language that is apt for the governance and the disclosure of CFRM.

The New Context of CFRM: Pros and Cons

The new regulatory context of CFRM has very similar characteristics worldwide. In short, new accounting principles have increased the visibility of derivatives in financial reporting and have also promoted transparency in the process of CFRM. Similarly, new corporate governance rules have attributed the responsibility of governing the process of CFRM to the Board.² As a consequence, the Board should promote better governance, which primarily means targeting, designing, controlling and disclosing the process of CFRM. Moreover, the Board, the auditors and the external financial analysts have become more deeply involved in the process.

This new context is a direct consequence of the impressive growth of derivative usage in corporates and should be welcomed, as it promotes a reinforcement of managerial discipline in the use of derivatives. However, the implementation of this new context has been accompanied by the emergence of some new problems. These problems are primarily due to the current prevailing culture of CFRM. Up to now, an accounting culture has prevailed (mainly driven by International Accounting Standards (IAS), FAS, CoSo and SoX), while the underlying economics have been very poor.

This culture, however, does not satisfy many practitioners. On one hand, financial reporting alone cannot thoroughly explain the economics of CFRM, as it is traditionally conceived by management. As a consequence, management is forced to adopt an approach to CFRM which is compliant, but is not necessarily sound from the economics perspective. On the other hand, the Board tends to accept the approach implemented by the management, thus privileging compliance and implicitly renouncing the appropriate governance of the process of CFRM, i.e., according top priority to corporate value creation. Even analysts, who are the final users of information delivered by corporates, are not satisfied, as they do not access any useful information from financial reporting, at least in terms of value creation.

² A good example is the recent corporate governance rules provided by NYSE, which states that audit committees should guide and monitor the process of CFRM, periodically assessing the hedging activity undertaken by the corporates. To this end, it provides that the members of the audit committee should have a specific competence.

These limits have stimulated a worldwide debate which has posed three main questions. Firstly, does new risk disclosure have an impact on the process of CFRM and derivative usage? Secondly, is the Board correctly informed in order to verify compliance, and moreover, to design, control and disclose the process of CFRM from the perspective of corporate value creation? Finally, is new risk disclosure useful to financial analysts, who should embed such information in the price of corporate securities?

Risk disclosure has a central role in the aforementioned debate. And, in fact, the crucial point of the debate is how to implement risk disclosure. Recent research gives some useful guidelines in this regard (Pollock, 2005). In Italy, for example, a recent study, jointly conducted by the Italian Association of Financial Analysts and Financial Innovations³, describes the main problems experienced by the Italian non-financial blue chips in the implementation of risk disclosure. The study documents a great asymmetry of accounting visibility between derivatives, which have become very transparent, and the underlying risk exposure, which still remains rather opaque. Sapra and Shin (2004) explain the main consequences of this asymmetry, which are linked to one another.

Firstly, if risk exposure is opaque in financial reporting, management can be forced 'not to use' derivatives, even when it should. The same behavior, i.e., avoiding the use of derivatives, may arise even when it is not possible to overcome the effectiveness tests, and thus, the rules of hedge accounting are not applicable. In both cases, if management wanted to use derivatives, it would have to accept its impact in terms of greater volatility of current earning and explain it properly to both the Board and the analysts.

All these problems are very well-documented in academic literature and are attributable to the presence of imperfect and asymmetric information between management and external analysts. This asymmetry has, in its turn, a direct impact on the predictability of future earnings, on the cost of capital, and consequently, on corporate value (Guay *et al.*, 2003).

The Latest Challenge: Risk Disclosure According to IFRS 7

Many listed corporates in European markets are now facing a new challenge, i.e., the adoption of IFRS 7, which has been in force since January 2007. In short, IFRS 7 requires more disclosure concerning the impact of financial assets and liabilities on both, current net earnings and equity. IFRS 7 also provides for a new set of qualitative and quantitative information concerning the risks of financial assets and liabilities, focusing on both risk exposure and corporate handling of liquidity, credit and market risks. On the whole, IFRS 7 emphasizes the problem of 'earnings quality' with regard to financial assets and liabilities. Many true innovations have been introduced in this regard. Let us examine some of them:

- Corporates may draw up a separate and unified risk report, which is expressly devoted to risk disclosure.⁴ This is a very important news, as it removes excessive fragmentation in financial reporting of current risk disclosure.
- Disclosure on risk exposure should be derived from the integration of accounting data and internal reporting.

³ Financial Innovations is an Italian independent consulting firm specialized in CFRM.

⁴ If this report is drawn up, it should be integrated into the financial statements. See Basis for Conclusions (BC) 46 of IFRS 7.

- A new methodology to run sensitivity analysis on financial assets and liabilities is provided for. This is a very important step forward, as it attributes a ‘corporate’ perspective to sensitivity analysis.⁵
- The scope of risk disclosure regarding financial asset and liabilities has radically widened. Up to now, risk exposure of only a limited number of assets and liabilities have been disclosed. This is namely the case of assets and liabilities involved in hedge relationships. IFRS 7, however, prescribes the disclosure of all asset and liabilities, at least if such a disclosure is considered ‘relevant’. In any case, risk disclosure has to be provided independently of the existence of hedge relationships.

All these revolutionary news run the risk of being improperly diluted by a misleading interpretation of IFRS 7. It would be a mistake, for example, to attribute an extremely lax interpretation to the general rule of ‘relevance’, which states that risk disclosure should be provided when it could have an impact on the price of the securities issued by the corporates.

Moreover, it would be a pity to repeat the mistakes made in the initial adoption of IAS 32 and IAS 39, i.e., to force the management to adopt an approach to CFRM that does not take the true economic drivers of CFRM into consideration, resulting in IFRS 7 being perceived as a mere problem of compliance to accounting rules.

The adoption of IFRS 7 should be considered as a rare opportunity given to the Chief Financial Officer (CFO) to disclose the economic contribution of CFRM both to the Board and the analysts. To this aim, risk disclosure should not be considered as a stand-alone activity. On the contrary, it should be integrated into the whole process of risk governance, i.e., targeting, controlling and disclosing the process of CFRM.

Risk governance is strongly influenced by the system of risk reporting, and in particular, by its language. Such a language is currently too technical, and moreover, it is too distant from the language of corporate value creation. To improve this language, we must thoroughly understand the link between CFRM and corporate value creation. The next two sections are devoted to this objective.

The Language of Value Creation Applied to Financial Risk Governance and Disclosure

Let us begin with the relation between assets, liabilities and corporate value. To this end, we may adopt an asset side type of corporate evaluation. Thus, the asset market value of a corporate, V is given by the arithmetic sum of—(1) The market value of Operative Assets, $V(OA)$; (2) The market value of Financial Assets, $V(FA)$; and finally, (3) The value of Risk Capital, $V(RC)$. Risk capital is the capital that may be used to finance unexpected losses, and is typically composed of financial derivatives, insurance contracts, liquidity expressly devoted to financing losses, unused financing capacity, and contingent capital.⁶

⁵ Unfortunately, this requirement is voluntary. The reasons are expressly described in the Basis for Conclusions (BC) 61 of IFRS 7.

⁶ For a thorough definition of risk capital see Doherty (2005) and Culp (2001). For the description of contingent capital see Culp (2002a) and (2002b).

By definition, the asset market value of a corporate is equal to the market value of corporate liabilities, i.e., equity (E) and debt (D). We may therefore derive the following equation:

$$V = V(OA) + V(FA) + V(RC) = E + D \quad \dots(1)$$

The value of financial assets and risk capital has three main types of impact on corporate value. Firstly, it has an accounting impact, namely on earnings and book value. Secondly, there is an impact on corporate risk. Finally, it has an impact on the sustainability of the operative assets value. From now on, let us focus exclusively on the impact of one component of risk capital on corporate value, i.e., financial derivatives.

Accounting Impact

Financial derivatives are included in the balance sheet at their fair value. If their fair value changes with time, such a change is included in the profit and loss account. Moreover, if derivatives are used for hedging purposes and the cash flow hedging rule is applied, a part of the change in fair value of derivatives has an impact on the balance sheet. This is the part of hedging that is effective. The eventual ineffective part of over-hedging is included in profit and loss account.

When derivatives are used for hedging purposes, it is better to carefully evaluate current earnings, in order to assess their sustainability, forecastability and volatility. In short, in order to facilitate the evaluation of 'earnings quality'.

Let us consider the case of a corporate that will issue a new floating rate debt during the coming year, as provided for by the corporate business plan. This corporate could decide not to hedge future cash flows generated by the future financial charges of the floating rate debt. Therefore, those cash flows would be exposed to interest rate risk.

The same corporate could also decide to buy an Interest Rate Swap (IRS) to hedge the cash flows generated by the financial charges of the floating rate debt. In such a case, the corporate could decide to apply or not to apply the accounting rule of cash flow hedging.

If it decides not to apply cash flow hedging, the change in fair value of the existing IRS should be registered directly in the profit and loss account even if, from the economic point of view, such a change should be attributable to the following years.

If the corporate, on the other hand, wants to apply cash flow hedging rules, the change in fair value of IRS would be divided into two components. The effective component would be registered in the balance sheet, while the eventual ineffective over-hedging one would be registered in the current profit and loss account.

Note how, in the previous three cases, i.e., non-hedged exposure, hedged exposure with or without hedge accounting rules, the entity of both earnings and book value change. Moreover, sustainability, predictability and volatility of earnings change as well. All this has to be carefully considered in assessing the quality of earnings, in accordance with the spirit of IFRS 7.

The Impact on Corporate Risk

Derivatives have an impact on asset risk, namely on corporate beta asset. In fact, beta asset is the weighted average of the beta of each single asset component.

As derivatives are commonly an asset component and have their own beta, their entity and quality have an impact on the beta asset. Moreover, the beta of assets is equal to the beta of liabilities, which, in its turn, is equal to the weighted average of beta equity and beta debt. As a consequence, derivatives also have an impact on beta equity and beta debt. Doherty (2005) and O'Brien (2006) illustrate this conclusion very effectively in two recent papers. A direct and quite obvious consequence is that each corporate should plan derivatives usage in order to satisfy the investor's expectations concerning beta equity and beta debt. Similarly, analysts should be in the position to understand which is the contribution of derivatives in terms of both equity and debt beta.

The Impact on the Sustainability of Operative Assets Value

Derivatives also have an impact on the market value of operative assets. The latter may be represented through the following equation:

$$V(OA) = Vu(AP) + Vu(GO) + TS - CD \quad \dots(2)$$

where,

$Vu(AP)$ = Unlevered market value of assets in place

$Vu(GO)$ = Unlevered market value of growth opportunities

TS = Tax shield

CD = Costs of distress

This equation is useful to show the two-fold impact of derivatives, and more generally of risk capital, on the market value of operative assets, $V(OA)$.

Firstly, derivatives should be used to finance the direct unexpected losses arising from $Vu(AP)$. Ideally, when derivatives are used for hedging purposes, their fair value should increase exactly in proportion to the decrease in $Vu(AP)$. Such an increase in fair value of derivatives allows corporates to finance direct unexpected losses, and hence, to restore the value of $Vu(AP)$.

Secondly, derivatives have an indirect impact on $V(OA)$. Such an impact is the consequence of the aptitude of derivatives to sustain—(1) The quality of expected cash flows and the unlevered value of growth opportunities; (2) Debt capacity and tax shield; and (3) The probability of default and the credit spread on debt. Academic literature has thoroughly explained that indirect impacts of derivatives are the main value drivers of derivative usage (Stulz, 2003).

As a consequence, derivatives should be used when they permit financing of the direct unexpected losses of $Vu(AP)$, thus avoiding, or at least minimizing, the indirect costs of risk exposure, which derive from the direct unexpected losses of $Vu(AP)$ and have an indirect impact on $V(OA)$, passing through $Vu(GO)$, TS and CD . Note that the indirect costs of risk exposure are firm-specific and cannot be eliminated through portfolio diversification. This justifies derivative usage.

Derivative Usage, Corporate Value and Risk Capital Adequacy

The impact of derivatives on corporate value may be better understood by remembering that each corporate creates (preserves) its value when current return, R_C is greater than

(equal) the expected return from investors, (R_E). Derivatives have an impact on both R_C and R_E .

The impact of derivatives on R_E is easily explainable. We can use CAPM, which states that the R_E of equity is equal to the sum of the risk-free rate and the product between the equity risk premium and beta equity. The latter, for the aforementioned reasons, is at least in part determined by corporate derivative usage.

The impact of derivatives on R_C is more complex. In short, we can use the following simple equation to express R_C (Penman, 2001, p. 141):

$$R_C = \frac{NE_1 + (P_1 - B_1) - (P_0 - B_0)}{P_0} \quad \dots(3)$$

where,

NE_1 = Accounting net current earnings

P_1 = Market value of equity at time 1

P_0 = Market value of equity at time 0

B_0 = Book value at time 0

B_1 = Book value at time 1 = $B_0 + NE_1 - D_1$

D_1 = Current dividends (a fraction of NE_1)

According to this equation, R_C depends on the sum of net current earnings and the periodical increase in the difference between, the market value and book value of equity. Note that derivatives have an impact on the different components of the equation.

Firstly, derivatives have an accounting impact on net current earnings (NE_1) and on the book value (B_0 and B_1). This impact is determined by both the decision to apply, or not to apply hedge accounting rules, and eventually, the type of hedge accounting rule to be adopted.

Secondly, derivative usage has an impact on the market value of equity (P_0 and P_1). The latter also depends on the aptitude of derivatives to—(1) Finance unexpected direct losses of assets in place, thus permitting them to be restored; (2) Sustaining growth opportunity and tax shield; and finally, (3) Maintaining the costs of distress under control.

So far, we have briefly described how derivatives have an impact on corporate value. However, corporations' need concerning, risk governance and disclosure, requires something more, i.e., a complete judgment on the adequacy of both derivatives and risk capital. This judgment requires us to verify the coherence between current (and eventually planned) risk capital and the following corporate specific aspects—(1) Economic drivers of CFRM; (2) Organizational and informational structure devoted to monitoring both risk exposure and risk capital; and (3) Risk disclosure. Let us call this judgment the assessment of Risk Capital Adequacy (RCA).

The assessment of RCA is a synthetic document addressed to the Board. Its aim is to verify the soundness of the process of CFRM in a specific corporate context, in order to identify and eventually overcome some limits. For example, the assessment of RCA

could signal that risk disclosure is not properly designed, and therefore, it causes an undesired asymmetry between the real objectives of CFRM, and the one perceived by the analysts and embedded in the market value of corporate equity. As a consequence, a new approach to risk disclosure should be provided.

The assessment of RCA normally feeds corporate risk disclosure, which should also be compliant with the requirements of IFRS 7. From this perspective, IFRS 7 is simply the framework into which the contents of the assessment of RCA should be included while preparing risk disclosure. Note how this perspective differs from that followed in the initial adoption of IAS. On that occasion, corporates had simply been concerned with accounting compliance, ignoring the underlying economic value drivers.

Conclusion

In the new context of CFRM, accounting data and internal reporting should be approached and integrated in a new way, to promote the language of value creation. This language, in its turn, should be integrated with other corporate specific information, to permit an assessment of RCA. This assessment facilitates the governance of CFRM, and moreover, feeds risk disclosure, which in its turn, should be aligned with the framework provided by IFRS 7. ♦

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