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# A shorthand survival kit for accountants and auditors in a turbo derivative world

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***Unhealthy skepticism***

If you were to surf the internet for ‘derivatives' you might get the impression that the derivative world is predominantly black magic grounded in fraud, abuse and error. If you're ‘googling' for ‘accountants' you might have the even stronger impression that accountants, as well as the auditors who watch their backs, are too often unfortunate fortune-tellers using foggy crystal balls to interpret that magic past, present and future. And while you were surfing for ‘derivatives and accountants' you would find IAS 39 repeatedly popping up like a very useful bad penny minted by the fortune tellers of the fortune tellers and sanctioned by a not-uncontested IASB global charter.

Surfing, you might almost forget that financial products such as derivatives and accountants and the IASB are for the most part constructive and indispensable elements in the mechanism that keeps much of our modern financial world moving effectively, micro and macro.

***An unhealthy state of denial***

Are you ashamed to be confused by financial products? Don't worry, there are plenty of connoisseurs who are also confused, be it at a higher level. Only if you're ashamed to admit it then do worry; it could be lethal. While there are plenty of people out there who are reluctant to acknowledge that they are baffled, their ranks are thinning. This is evidenced by the recent groundswell of  refreshing  and helpful confessionals by people we always assumed knew their business.  And we can be sure that we'll hear more such acknowledgements as and when the intricacies of fair value accounting hit home, full blast and in slow motion.

Complex financial products and structured financial products are by their very nature conducive to confusion and susceptible to being manipulated in design, in trading or in accounting. Departures from the generally accepted or acceptable, when it happens, have in common a slow discovery process. This is especially true when it is not clear up front what the risks and trade offs of the products themselves are. Additionally, embedded risks can escape scrutiny at entry because they are not understood by buyer and seller. It has happened, is happening, and will continue to happen. Moreover, in the world of finance, what seemed complex yesterday is often unremarkable today. And what is unremarkable today can become complex again tomorrow if used in combinations or permutations that out-stretch the imagination. What is agricultural fertilizer for the one can become, when mixed with another garden-variety base chemical, a dangerous explosive for the other. But that is not reason enough to ban fertilizers.

***Derivatives: a crucial instrument dressed in a mixed blessing***

Derivatives play a crucially important role in the financial risk management of most larger companies and financial institutions and for very good reasons. They can mitigate, or stimulate, risk and bundle, or un-bundle, a host of inherent or specific financial risks. In short, without derivatives the world would be a much riskier and less liquid place. But if misused or misunderstood they pose their own risks, in trading or in risk analyses or in accounting.

***This toolkit...***

This toolkit is a personalized summary, in the form of seven mini-reasoned theses, moving from the micro to the macro in the world around us. It is a rank and file, bottom-up look at the world of accounting for, and auditing of, derivatives. We hope this fast track ‘easy-on-the heart heavy-on-the-stomach' test kit offers a practical opportunity for a personal professional risk self-assessment. Hopefully when the next crises comes around, which is inevitable, accountants and auditors alike will have a better chance--no seating guaranteed-- to find themselves on the right side of the table. As a next-best, we hope it gives perspective to those who have to explain themselves; and, last but not least, may humble those who, on our behalf have the privilege of the prosecution.

**1) I keep my skills honed in understanding the language of finance.**

We believe the language of finance, and the products that go with it, has outpaced itself and is stretching the accounting profession's ability to convincingly identify and extract the risk profiles and the substantive economics of too many financial/derivative products.

Particularly new or exotic cutting-edge products like complex structured concoctions have become the toughest to break down to essentials, although we realize that vanilla products form, and will continue to form, the bulk of the ballooning derivatives market. This moving target and the correlative exposure at the individual level requires ever stronger internal checks and balances at the corporate level to make sure the organization as a whole is not at risk of not recognizing the substantive economic and risk profiles of their trades.

This skill risk becomes greater to the degree that there is a too big dependency on a thin layer of specialists supervised by a fragile layer of, mostly, generalists. And managerial and oversight responsibility and comfort, at all levels, becomes vulnerable. The road to any derivative crises is strewn with bodies who were presumed to understand, or for others to understand, and we found out the hard way they did not. Denial and pretense probably take down more institutional empires than do rogues, and make for plenty of innocent victims in the process. The best defense mechanism, for all control valves at all levels, next to proper training of course, is the first law of gravity for any professional:

**If you don't understand it, don't suggest you do.**

**2) I adequately factor into my work the sometimes inadequate degree to which the financial markets understand their own products.**

If you don't, you probably also do not realize that many of the calamities that we have seen are misunderstandings among the presumed financial-product experts as to what exactly they were buying or-credit derivatives being a point in case- a lack of clarity between (presumed) informed buyers and sellers. If parties do not (quite) understand what they are trading, how are their accountants supposed to properly account for it?

If neither is willing to step forward and acknowledge his uncertainty, it is an accident waiting to happen. As long as there is no up-front risk profile specification requirement for derivative-like products or constructs, such misunderstandings will always remain possible, especially for the more creative frontier products. Surprisingly, we require product warnings for most consumer products, but we don't for derivative business-to-business trades, however complex they may be.

If you do not understand the controls risks that go with intransparent (by design or by default) products or if you do not understand whether a product is crystal clear or obscure, or the valuation models used oblique, stay away from suggesting you can deal in, or account for, or audit it; whatever the workplace pressures to pretend you do.

Let us remember, complexity can also be a premeditated attempt at confusing counterparties, including their accountants and auditors. Finite (re) insurance products being the latest casualty of making the wrong history.

**Again: if the industry does not see it, do not suggest you do.**

**3) I do not give derivatives, including IAS 39, a pass just because they have nothing to do with the (SME) practice I work in.**

Good. Even if you don't come across derivatives in your present job or practice; or you think you only practice in or with small or medium-sized companies; or you think the entities you deal with escape quality accounting standard requirements, pay attention. Remember that most regulations (tend to) define SME's in monetary rather than risk-profile terms.

Using the traditional size criteria for SME's has become a dangerous choice because of the circularity of it all. A small company that is small only because it does not have to put its derivatives on the balance sheet (because it is small) is a danger to itself and to the rest of the world, and the accountancy profession is fooling itself by closing its eyes.

We urgently need risk based definitions of SME's, but we also need to recognize that with the advent of fair-value accounting simply staying out of the fray and sitting on the fence is not adequate. A traditionally defined SME or a GAAP-exempted entity might hold a lot more economic exposure than meets the eye relative to the non-IFRS compliant balance sheet. The profession cannot be too pro-active in creating awareness on that front, irrespective of the pressures for simplified (SME) accounting.

**You cannot be pertinent enough in asking yourself if the small -or not so small  off-shore or GAAP-exempted- companies you work with will be a danger to your professional reputation**.

**4) I fully understand the systemic risks of IAS 39.**

Congratulations and be careful, because few do. Which may give you pause. IAS 39 signifies major progress--albeit slow motion--given where we come from;and the generation of inconclusive debate; against the background of an ever more rapidly changing derivative landscape.

But IAS 39 is not an end station. It is and will continue to be a treadmill. Regulation will always have trouble keeping up with new market developments. IAS 39 is already doing its good work ‘outside-in' by changing the risk management perceptions and behavior of organizations and by smoking out the latent risks of the smoke-and-mirror small print in financial products. But thinking of it as the silver bullet for financial products control is over-simplifying. IAS 39 is work in progress, part principle, part rules, part fair value, part historic cost ("mixed attribute") driven. Where it is fair-value driven, there is more than often no market to price it unequivocally. Where it remains historic cost driven it compounds  the confusion around the nature and quality of the bottom line.

IAS 39 is an incomplete road map that tells you in qualitative terms where and what the multiple--and beyond a certain point also competing-ultimate measurement destinations are. But it tells you only piecemeal how to get there. It relies heavily on judgment in what is for the most part a high-pressure and high-expectation corporate climate setting.

Given the background of its ‘substance over form' imperative, the internal inconsistency associated with mixed attributes and its mutually competing overall qualitative characteristics,  IAS 39 also constitutes a potential professional fire hazard. Applying IAS 39 becomes as challenging as turning ‘Fraternite, Egalite, and Liberte' into a single democratic delivery platform. Remember that in the more than two hundred years since the French Revolution, we've had four bloody European wars to get us where we are today--and we're not there yet. Prophetically, IASB Chairman David Tweedie promised not so long ago, in the context of the fair-value debate, that there will be more ‘blood in the streets'.

If you do not understand that IAS 39 is not a cookbook for dummies, you are a professional danger to yourself. By the same token, looking at IAS 39 as picture postcard holistic gospel is also nonsense. It then becomes  quicksand for those who have not understood the challenging ‘substance over form' mindset that comes with an inevitably piecemeal toolkit.

Improvisational country-kitchen home cooking, and that for a diverse guest list, will inevitably remain an important--and rich--function of the new cuisine of the IFRS accounting regime. This gives reason for celebration for any professional worth his or her salt. But it also signals for a degree of caution in that same professional and asks that he or she be willing to address the challenges to our core skills that are circulating out there.

**Go through acceptance procedures, each and every time, with open eyes and ears, and be fully aware of the judgment and spine it will take to keep wishful thinking and denial out of the ultimate accounting/audit equation.**

**5) I fully understand the macro risks that go with IAS 39.**

 "Why should I also question whether and how it all adds up?" could be the first and understandable reaction of the individual practitioner or the profession itself.  "Worrying about anything beyond the immediacy of our jobs is for the regulators, standard setters, and our professional accounting organizations, not for us individual professionals".

And it's true that in the context of daily work pressures, we have enough on our hands. But a parochial attitude leaves us exposed at  macro control level, leads to partial blindness, and is consequently dangerous to our personal professional health. Individuals, and their organizations, have a professional interest in getting things right beyond their immediate front door--where we find our own (quality) control environment.

We have to understand that derivative numbers are getting so big that the world cannot ignore the fact that, both thanks to and despite IAS 39, there can be asymmetry in earnings recognition between parties on the opposite side of the same zero-sum transaction. There is no monitoring of possible systemic double-counts and, by extension, the possibility of economic bubbles. There is at present no one in charge, or able, to tell us whether the whole is more or less than the sum of its basically zero-sum-transaction parts. We do not have double entry bookkeeping for earning recognition at the macro level.

IAS 39 has innate features, beyond implementation and teething problems, that may put a practitioner to his surprise on the wrong side of the accountability table come judgment day. Creating artificial legal constructs with third parties for the accounting effect only; or the orchestrated abuse of IAS 39 internal inconsistencies; or pushing one's luck by gaming its judgmental decision tree, are usually not beyond determined parties going for an easy buck.

This macro exposure is part and parcel of any professional's micro control environment. Being unaware, or even dismissive, of parties gaming the rules once the rules of the game are established, may undermine one's professional health and that of the organization and/or clients and users one serves. Especially so in an environment where the incentive systems still gravitate, and will continue to gravitate, around tempting income management.

**Macro exposures are exposures of our immediate work environment; they can backfire. Therefore, we have to take them serious.**

**6) I understand the way regulators tick, and I acknowledge their authority and best efforts, but I am also well aware of their inherent weaknesses and the impact they can have on my work.**

Good and bad, depending what you do with this smug wisdom.

Regulators play a crucial role in standard-setting and compliance enforcement and sometimes in both. They do not operate in a vacuum but are part and parcel of our socio-political fabric and hence are as politicized as any other creature (in fact more so more often than not). In enforcement they have the natural advantage of the benefit of hindsight.

Regulators are subject to the same professional-technical conundrums as everyone else and are caught up in yesterday just like you and me. In fact, in many ways,they are just like the rest of us. Everything they do today is influenced by what happened yesterday, and as a consequence most of the new regulation we see emerge is reactive at best, always one step behind business developments, fraught with internal consistency issues and mortgaged by pressing legacy problems and a hunger for showing ‘progress' is being made, hence rushed.

Regulators' good work is hardly ever the silver bullet for solving to-days or tomorrow's problem. Regulation is seldom ‘bull's eye'; it is mostly ‘progress', the opiate of regulators and their political peers. Regulators, too, are faced with ever-moving targets. There are good examples of regulatory excellence, mostly crises born (SOX/IFRS). However, regulators are also all too often grossly under-funded to meet their systemic remit; and hence never in a position to give positive reasonable compliance and/or systemic assurance at their operating level ( just in case you wonder why you are the first and last in line to give positive assurance, whatever). Therefore, regulators are  part of the solution but also a chronic  part of the problem, just like you, your firm and your professional institute.

All of this applies equally to the complex business of derivatives and the accounting and auditing thereof. Where confusion reigns, regulators, generally, will be as confused as the rest of us, albeit at a higher level. It may look differently, because they do not annually sign off on ‘mission completed'. But don't let that lure you into a false sense of security. All of this is not meant to offer anyone  excuses, but to make clear that regulators cannot possibly make up for, and prevent in all cases practitioner's weaknesses--and vice versa. Regulators are an imperfect complement to, not a perfect substitute for, your own professional responsibility.

**Once the rules of the game have been established, the game of the rules will start and that will apply to regulators and practitioners alike. If you do not understand that or cannot stand the heat, move to another kitchen**. ***If you do understand it, factor it into everything you do, make sure you do it right and properly document your analyses and decisions, time allowing.***

**7) Taking zero risk is my professional performance standard.**

If it is, you are probably wasting everybody's time and money, including your own. You are in the wrong profession.

Zero risk and absolute assurance is not of this world. Even unqualified reasonable assurance brings you only a little closer to reality for the same reason: The audit profession has found that out the hard way over the last decade by throwing unqualified reasonable assurance -clean- opinions--at about every risk situation one can think of. The worst cases need no reminding; and are still popping up every month it seems.

‘Reasonably qualified reasonable assurance' would be the best benchmark for the future; and very informative at that. This applies to the private as well as the public sector. Because both sectors are expectation-managed by a leadership culture that has too often turned Napoleon's definition of leaders -"dealers in hope"--into "wheeler dealers in hope". We all risk  exchanging a blind eye to on the ground realities for a black eye when realities catch up.

The reality checkers of this world, accountants and auditors, have too often been sailing along with structural optimists to their own demise. In the public sector this is evidenced by chronic understatement of the ex ante risks that go with much of the business of government (viz: accounting for ‘oil for food'). In the private sector it has manifested itself by accountants and auditors accommodating the pressure to meet expectations through bland clean opinions, whatever colorful the risk landscape. The (audit) world would be a much safer place if clean opinions were to be banned for a period of ten years. Ballooning creative financial instruments, in combination with fair value accounting, will test our will to be serious even more seriously in the coming decade.

**It is time to get serious with wholesale acceptance of the dignity and informational value of properly nuanced--reasonably qualified, reasonable assurance predicated--comfort statements. An acceptance that cannot be imposed from the top down, but will have to trickle through from below, up. That's where you live. And the world- including your own- will be a safer place.**

**BOX 1**

**Some examples from the derivatives-shop**

... target redemption (tarns), snow ball, range accruals, CMS linked, knockouts, barriers, multi-currency chooser, CMT-linked, reverse floater, power dual currency reverse floaters, constant proportion portfolio insurance, bandwidth derivatives, pollution allowance derivatives, credit default obligations squared, credit default swap, total return swap, ABS, MBS, basket option, bear spread option, binary option, caplets, cash-or-nothing binary, compound option, crack spread options, differential swap, quanto swap, digital option, binary option ...

**BOX 2**

**NIVRA: Explanatory boxes to derivatives survival kit**

Mixed attribute accounting is a mostly unhappy mix of different concepts of  measurement - the economic concept of fair value and the ‘mechanical' concept based on historic cost- in the same set of financial statements.

Mixed attribute accounting is often a symptom of agreement by exhaustion we often see in accounting standard setting: Approving parties being keen to come to closure, and willing to sacrifice the internal consistency of the embedded profit concept of the standards under review.

IFRS and US GAAP both are predicated on such schizophrenia, allowing all to claim that we have made progress by piecemeal introduction of an economic concept of measurement; which we have. It requires all, and sometimes allows some, of the derivative assets and liabilities to be ‘marked to market'; but does not require the same for the underlying  assets and liabilities; leaving the nature and quality of the resulting bottom line open to bemusement at best and wonder at worst. All of this can be explained  away with the introduction of "an accounting concept of profit", allowing for "accounting by convention". But a convention that may not add up in terms of internal consistency, and, externally, also lead to quite different accounting treatments by counterparties for the same instrument/transaction, mortgaging a sound macro concept of income measurement.

A lot has to do with the political or politicized nature of accounting standard setting, the nature of accounting as language of business, language being power, some corrupting, some just serving vested interest, some pragmatic, well intended but lacking spine, some high- pressured by time constraints. And as we all know from our physics class: under pressure everything becomes fluid, even accounting solutions.

E.g. the infamous EU pressure on and carve out provisions for IAS 39 has put more mix into the draft IAS 39 already very mixed attribute features. In public sector accounting we find it back, duly euphemized, in the form of ‘modified accrual accounting', the same unhappy mix of cash based and accrual accounting.

If standard setters continue to mix mixed attributes with mixed attributes one ultimately ends up with too much mix and too little, if any, attributes. It is like being half pregnant: too much expectation, too little to wrap your arms around.

The pain that goes with the resulting duality or ambiguity becomes manifest if one were to try out IFRS/US GAAP accounting to one's own private situation. See BOX 3.

Any resemblance with the present fate and state of the EU is purely coincidental.

**BOX 3**

**A -mixed blessing- family affair**

The ambiguity and duality of mixed attribute accounting can also be illustrated in the context of anyone's family ambiance:

Suppose you lend each of your ten children $ 100.000, at different times, with different maturity dates, fixed but different rates for each. Hardly a homogeneous easy to hedge lending portfolio, to say the least, so financed in your parental innocence with ten variable interest loans from your friendly banker with the same maturity dates.

Your brother John lends his one and only child the same total amount, 1 million dollars, at the pertaining variable market rate and a straight shooting amortization schedule. He financed it by arranging a  loan from his friendly banker, aligned with the loan conditions imposed on his offspring, perfectly matched, however at a fixed rate.

Mother of course immediately looks through the asset/liability interest risk/mismatch of each of her two children and arranges an interest swap between the two. You both oblige and now you have a much more palatable interest risk profile. You pay fix interest rate to your brother and receive variable from him.

New Years' Eve, the family gets together and your father, a prominent accountant, starts drawing up the results of this all based on IAS 39. In the meantime the interest rates have dropped by halve since mother's intervention.

Father proudly declares your brother's position to be stable, homogeneous on all sides and perfectly matched on all fronts, with balanced exposures. What goes up on this side, goes up on the other, whether or not the accounts show it; what comes in goes out, a perfect wash.

But to you he says: "Sorry son, mixed attributes, mixed feelings. I know my wonderful grandchildren owe you interest at rates double of what the markets go for these days; I know they will be able to pay up; but your messy lending portfolio, despite its increased value is too nebulous for any accountant's comfort to celebrate at this juncture. Hence don't count yourself rich till they pay. At the same time you owe your brother an amount that as a result of same interest rates changes has increased by 50%, but does not qualify as a perfect hedge. Hence you will have to swallow your swap losses out of current year's income; unless you choose to offend my preferred accounting standard setter who insists on perfect hedges. You can also look for another accountant and do some opinion shopping; it would not be the first time it works".

That festive evening the champagne tastes bitter: You swallow, brother John hallows, father avoids mother's eyes, mother urgently needs another drink, double please.