Risk Assessment

Gerben Everts of the Dutch AFM moderated a discussion on Risk Assessment with the following panelists: Tim Gustafson, US PCAOB's Office of Research and Analysis; Christian Leuz, University of Chicago's Booth School of Business; Jules Muis, former World Bank Vice President and Controller; and Craig Lewis, Vice Chair of the International Organization of Securities Commissions (IOSCO)'s Committee on Emerging Risk. The session first addressed identification of systemic risk and then explored how regulators translate identified risks into their day-to-day work. The IOSCO representative described efforts to identify key risks that affect regulated activities, as well as risks that reside at the periphery of regulated markets. Key focuses of IOSCO's Committee on Emerging Risk are the over-the-counter derivatives market, where regulators seek to understand potential for the build-up of risk and how such risks might be mitigated; the impact of monetary and fiscal policy on emerging markets, in particular considering the high levels of capital that have moved to those markets in search of yield and the potential impacts should that flow of capital reverse; and liquidity risk in the asset management sector. Auditors and their regulators should be aware that realization of these risks can result in distressed markets and valuation uncertainties.

Another panelist explained that systemic risk is not front-of-mind in the audit profession. This is troubling considering that accounting, audit and corporate governance are economic fundamentals that are key to systemic risk management. This has been demonstrated historically through the Latin American and Asian financial crises, and recent reforms have only tinkered at the margins of underlying issues. The panelist holds that regulators should be required to make clear statements regarding the absence of systemic risk to markets or, if such an assertion cannot be made, they should explain the qualifications that prevent such an absolute conclusion. Obligations of this type would improve regulators' accountability and transparency regarding the build-up of risk. Another panelist explained the importance of an audit of the accounting data that is used for financial institutions' prudential measures and by analysts and others to derive entity valuations. Financial information provides a picture of the reporting entity's fundamentals, and external assurances inspire trust in the information's reliability. According to this panelist, regulators should adopt a dynamic, risk-based approach to regulation that monitors the build-up of risk and requires oversight and enforcement that is counter-cyclical to risk. Research indicates that earnings management increases with economic booms; regulation and oversight should likewise increase as the economy heats up. Regulators must be prepared to face pressure against their increased scrutiny as risk increases.

Another panelist described efforts an audit regulator might undertake to monitor risk in order to implement a risk-based allocation of inspection resources. It is a challenge to address risk in large, complex institutions that could pose systemic risk, not least because of the complexity of their businesses and the large number of subsidiaries in which risk may reside. Audit regulators should be open to communications with bank supervisors to enable exchange of information that may facilitate identification of risk.