Your Financial Statements Conceal More Risk Than You Think

There are two types of companies in this world: those that manage risk to promote security and stability, and those that do not. The prior offer financial statements that can be trusted without worry. Companies that manage risk are safer and more secure, and their financial statements can be relied on. The latter suffer from greater vulnerability and their financial statements are misleading, often riddled with subtle risks that are easily missed.

As CEO, you must know whether your company's financials are secure and trustworthy or vulnerable and risk-laden. Not only is this knowledge important to you, but it is also of great interest to your lenders. Naturally, they want to know that your financials can be trusted.

The balance sheet from your company displays assets that are supposed to be constant and stalwart: the unspoken promise to your lenders is that, even following some sort of financial disaster, those assets will remain as valuable and available as ever. Of course, such balance sheets display liabilities as well. But even with uncontrollable factors in play, the goal is to ensure that those liabilities do not unexpectedly and significantly increase. That is the ardent wish of any lender who values their money, and it should be your goal as the CEO as well.

Unfortunately, the audit process does not always accurately reflect that these goals are being met by your company. The audit process can be misleading when a company does not manage risk. Such companies often look very profitable on the surface, but only because they have lower initial expenses thanks to their lack of risk management.

We'll cover a perfect example of this in the next section.

Risk Capital

Capital is the lifeblood of any firm: it is needed to finance nearly all of its day-to-day operations, including building rent, covering payroll, purchasing materials, and much more. This is referred to as operational capital, which is measured by traditional financial statements.

However, a firm also requires capital to finance risk: in other words, to pay for unexpected expenses, such as those caused by a lawsuit or a serious accident like fire or flooding. This is referred to as risk capital. Despite its importance, it is not measured by traditional financial statements like operational capital.

Three sources provide risk capital for a firm:

1. Cash that the firm has available on hand. To meet the many risks a firm will face during its operation, such cash would have to be extremely significant, but even

then, it would likely not last long with all of the competing demands for its use.

2. Off-balance sheet capital, such as credit lines, used to finance major unforeseen expenses. But as with all credit, such loans must be repaid in time.

3. Insurance. By being insured, a firm can transfer the consequences of a financial loss to an insurer, in exchange for the premium the firm pays for their insurance.

Thus far, it would seem like risk management is solely about having enough money on hand to deal with unforeseen expenses. However, there is more to it than that. Risk management isn't just about paying for losses, but also preventing them from happening at all. Safety measures, quality control efforts, subcontractors, business partners that share some of the financial burden, and transference of risk to customers are all ways in which financial losses can potentially be prevented. By taking such measures, the need for risk capital is reduced.

Of course, that is very valuable. After all, the types of risks faced by a firm regularly could be devastating. If a lawsuit goes bad, the company could owe tens of millions of dollars to a plaintiff. The entire facility could be rendered inoperable by an accident such as a fire or flood. But despite the massive financial loss these risks could incur to any firm, the management of these risks is barely, if ever, reflected in regular financial statements.

That's because financial statements do not consider risk capital. At most, financial statements consider a cursory inspection of an insurance schedule as due diligence regarding any risks they may face. Whether or not set insurance policy limits are sufficient to cover the actual potential risk expenses a firm could face, not to mention whether the thousands of pages of terms and conditions actually cover what is needed, is not considered by such a lackluster audit.

This isn't even the full extent of the problem. Loss control and contractual transfer are also not considered in these financial statements. What this means is that potential risk is not being considered on a qualitative or quantitative basis, which obscures the true reality of a firm's financials.

When risk capital is not used as a factor to compare various firms, all those financial statements look alike. They all seem to be positive and profitable on the surface. A popular saying best put it into perspective: "All boats float alike when the weather is calm."

When everything is going well, the lack of funding for risk management seems more profitable for the company and the investors. But when the storm does hit, and there is always a storm coming, the perceived gain of saving money on risk management is drastically overshadowed by the massive deficit incurred by the disaster. Think of it like buying a case for a phone: sure, you will save money on the phone initially if you do not buy a case for it, but when you drop the phone and break it, the cost of repairs or replacement will far outstrip the cost of the protection you could have paid for to prevent it.

Risk-Adjusted Return on Capital

Here is a more relevant example to consider. Imagine that there are two companies that both generate a 15% return on equity. One of these companies completely manages risk, while the other leaves such things to the whims of fate. Initially, both companies appear equal according to the financial statements. And admittedly, they will be equal, at least until something bad happens that requires capital to cover it. Once some financial disaster strikes, the first company that was managing its risk will be much better off than the one that wasn't, since the latter will be forced to cover a huge financial deficit they had not prepared for.

This reality is why the true measure of a company's value is its return on *economic capital:* the combined total of both operational and risk capital.

No matter what a firm does, its activities will generate risk. And no matter what, a certain amount of capital will be required to address that risk. However, the more risk that can be prevented or transferred to other parties, the less risk capital a firm will need. For instance, if potential risk expenses are covered by an insurer, off-balance sheet capital is being used, which reduces the firm's need for on-balance sheet capital. The premium the firm pays to the insurer would be considered an expense on the income statement.

Back to our example of the two firms, if they both generate $.15 for every dollar of capital that is measured by their financial statements, then the return on equity is 15% for both firms. The first in our example, Company A, completely manages its risk by using insurance and loss control. Because of this, the risk capital required by Company A is zero. This means that the risk adjusted rate of return for Company A is actually 15%, as reflected by its financial statement.

However, the company that does not take any steps to manage risk, Company B, has no risk capital ready to deal with financial losses. Due to this, any financial risks they have to address will have to be paid either with cash or loans. For the sake of this example, assume that risk capital of $.75 is required by a firm for every dollar of operational capital. This would mean that the risk adjusted rate of return for Company B is: $.15/(1+.75) = 8.5\%$. As you can see, this is far less than the alleged 15% shown on Company B's financial statement.

This is the little-discussed problem with traditional financial statements. Because they do not measure risk capital and the adjustments it makes to a firm's ROE, Companies A and B seem to have equal ROE when they truly do not.

This concept is often proven by the SEC when it reacts to major crises. The SEC often advises public companies to disclose how they are managing particularly potent risks such as cyber-attacks and terrorism. However, merely noticing the risk of an event that has occurred and reacting to it is not risk management. Risk management addresses a potential problem before it happens, not after.

After all, two tenets of risk management are always true. First, historic financial losses require an extensive experience period before they can be used as valid predictors of future risk. The more remote and severe the historic loss is, the longer the experience period must be. Secondly, recency bias, a psychological phenomenon that causes people to place arbitrary importance on events that have recently occurred, must be ignored when assessing risk management. Even so, we should be grateful to the SEC for occasionally illustrating the fact that financial statements are incomplete without risk management factored into them.

Having said all of this, our intent is not to advocate for a change in how financial statements are handled. It is up to the CPA world to make that decision. Our intent is to assert that, with the way financial statements exist today, provided that your CFO is not offering risk management reports, you as a CEO are not getting a clear image of your business and its profits.

After all, you cannot truly manage profits unless you also manage losses. The potential cost of making money impacts how much you're really making. By ignoring potential financial risk, a firm is allowing their profits to be entirely dependent on luck, and whether they suffer some financial catastrophe on any given day. Quarterly profits are unreliable since the numbers can be swiftly manipulated. Even if a firm has years of profit and good fortune under its belt, that profit cannot be trusted if no risk management exists, since those profits could disappear on any given day if a financial disaster strikes. A firm that is truly secure, stable, and reliable not only produces consistent financial numbers for a CFO to take pride in, but also manages the risks that could impact those financial numbers negatively.

As a CEO, you must keep this in mind. If risk management is not being factored into your financial reports, you run the risk of growing complacent with your company's preparedness for disaster, and by extension, you risk its profits and net worth.