

Accounting for crises

Tony Jaques argues that those at the financial coalface of an organisation should be involved in crisis planning, especially as they play a key role in detecting the warning signs of a potential crisis such as fraud or insider trading.

Crises cause a range of impacts – organisational, reputational, operational and political – but no crisis impact is typically so immediate as the financial fallout.

Think no further than BHP Billiton which lost \$8.9 billion of market value in a single day in May when the Brazilian government announced a mega-claim against the company arising from the Samarco dam collapse. Or when Crown lost \$1.3 billion of market value on one day in October when some of the casino company's employees were arrested in China. Or think of the Costa Concordia disaster off the coast of Italy, where refloating and removing the sunken cruise ship took total costs to well over £1 billion.

It might be tempting to think that such massive crises are exceptional and only apply to big multinational corporations. And it might even be tempting to imagine that it nearly always turns out okay in the long run. But the data proves otherwise.

The cost of a crisis

Any company which says "Let's not over-plan for a crisis – I am sure we can respond well" should consider a study of Australian crises over a 10-year period, undertaken at Melbourne University, which showed that one in four crises cost the organisation affected in excess of \$100 million.¹ In addition, more than 25 per cent of the organisations went out of business or ceased to exist in their current form.

And if that wasn't alarming enough, consider a famous study at Oxford University into the relationship between crisis preparedness and the effect on share value.² The researchers found that when a crisis struck, the share price of badly prepared companies fell further and recovered slower than for well-prepared companies. In fact, 12 months after a crisis, the share price of well-prepared companies was, on average, 22 per cent ahead of the badly prepared.

In the face of such stark numbers you might think that any organisation's accounting and financial experts would be intimately involved in crisis preparation and crisis planning. But, sadly, here again the facts suggest otherwise.

Why finance staff should play a role

There is not a lot of research available into the specific role of money managers in crisis preparation, but a good indication of the worrying reality can be seen in a survey of financial analysts and investor relations officers (IROs) at companies across Canada and the United States.³ It found that while many companies are mindful of the potential damage crises can cause to their sales, reputation and share value, few have an effective crisis management plan in place to deal with negative scenarios – and if they do, it is likely out of date. Of responding analysts, 85 per cent said a corporate crisis – fraud resulting in accounting restatement – has the greatest negative impact on a company's value, yet over 50 per cent said their company plan prepared them only for an operational crisis. Furthermore, 50 per cent didn't even know if their company conducted crisis simulations and 55 per cent didn't know if the crisis communications plan is updated after a crisis.

Commenting on these conclusions, Tom Enright, President of the Canadian Investor Relations Institute, said: "Given the importance of the IRO's role during a crisis, they need to play a much larger role in developing the crisis communications plan, executing crisis drills and regularly updating the document. Their involvement in the process should be from beginning to end."

Yes, they should be involved. The question, of course, is why aren't they? Anyone who doubts the importance of this challenge need only look at the dark history of financial and accounting-related crises. Accounting fraud and financial mismanagement represent very

high levels of crisis risk, yet such crises continue to grab the headlines.

Raising red flags

Australia has its own rich catalogue of such crises – Bond, Qintex, Pyramid, HHH, OneTel, Storm Financial, Great Southern Plantations and a string of others. But three high-profile international crises have special relevance for crisis preparedness and prevention.

Crisis experts know that most crises are preceded by red flags, and the detection of warning signs should be a key role for accountants and financial managers. But business crises often reveal a litany of warnings which were ignored, and resulted in disaster.

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In 2008, French bank Société Générale lost €4.9 billion through the activities of a single rogue trader, Jerome Kerviel, who went to prison. But an independent panel found the company failed to act on 75 red flags or early warnings over the previous 24 months.

Kerviel consistently argued that managers had turned a blind eye to his profitable transgressions, and in mid-2016 a French appeal court threw out most of his financial obligation to Société Générale, declaring that the bank's "multiple faults" meant it "had a major and decisive role" in allowing the incident.

Shortly afterwards in the United States, in the wake of the US\$65 billion Madoff



investment scandal, Securities and Exchange Commission Inspector-General David Kotz admitted that the agency missed “numerous red flags” from 1992 until fraudster Bernie Madoff was arrested in December 2008. Inspector-General Kotz conceded that five separate investigations into the affair had been bungled.

More recently, consider the ‘London whale’ trading scandal which JP Morgan Chase CEO Jamie Dimon initially dismissed in 2012 as “a tempest in a teapot”. However, it cost his bank a US\$6.2 billion loss and its market value fell US\$40 billion in a matter of weeks. Most importantly, a US Senate Panel reported that bank management had “disregarded multiple warnings”, including the fact that internal risk limits were breached more than 300 times. JP Morgan eventually paid over US\$1 billion in fines to regulators in the United Kingdom and United States, and CEO Dimon conceded that the trades were “flawed, complex, poorly reviewed, poorly executed and poorly monitored”. Not much comfort for the investors who lost millions and are still pursuing legal action.

The crisis-proof organisation, where everyone’s accountable

These cases, and many like them, go to the heart of the new concept of

‘Crisis Proofing’. While most companies have auditors, fraud units, risk assessors and forensic accountants, these activities are typically seen as part of asset protection and risk management rather than as core elements of crisis prevention and preparedness.

Crisis management is not just about what to do when crisis strikes.

What is needed is a new approach which recognises that crisis management is not just about what to do when crisis strikes, but about what senior executives can do to reduce the chances of a crisis happening in the first place. It recognises that crisis management cannot properly be delegated down the organisation to technical managers in Corporate Security or Environment, Health and Safety or Public Affairs. Instead, it has to be an integrated, cross-functional activity led by top executives who understand the critical role of all departments in the organisation, including the accounting and financial functions.

The crisis-proof organisation demands executives and managers at all levels who understand the threat generated by crises and

who are prepared to do the work necessary to protect their organisation from the terrible impacts a crisis can bring. 

- ¹ Les Coleman (2004). The Frequency and Cost of Corporate Crises. *Journal of Contingencies and Crisis Management*, 12(1), 2-13.
- ² Rory Knight and Deborah Pretty (1999). Corporate Catastrophes, Stock Returns and Trading Volume. *Corporate Reputation Review*, 2(4), 363-378.
- ³ Canadian Investor Relations Institute (2011, 12 April). Few companies are prepared to manage a crisis. *Business Wire*.

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