Financial Reporting Challenges in Investment Banking

A practical guide to reducing risk in the Financial Reporting process
The financial services landscape is undergoing a fundamental change. Timely insight and clear focus has never been more critical. With this in mind the Financial Services practice in Accenture is producing a series of ‘Industry Insights’ to help the industry address the challenges it faces. The series will focus on the five key issues facing the industry in the UK and Ireland:

• The regulatory challenge
• Innovating for the changing customer
• Globalisation
• Restructuring for growth
• Rebuilding trust and reputation

This point of view explores how Investment Banks can tackle financial reporting challenges and reduce risk in the Financial Reporting process.

What’s next in the Industry Insights publication series?
Over the course of the next several months, we will be issuing points of view addressing different aspects of each of the five key themes identified above. Below are the upcoming and recently released publications in the series.

What’s next?
• Accenture FS Online Digital Diagnostic Scan
• The UKI Customer Service Survey 2011
• Managing Regulatory Change in Banking and Capital Markets
• The Digital Insurer

Recently published
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• Banking 2012: Revenue Growth and Innovation
• Spotlight on Solvency II for Insurers
• If a Country Leaves the Euro…

Contact Us
To know more about the Industry Insights Research, Upcoming Events or Future Publications please contact:

James Sproule
Financial Services, Research
+44207845963
james.sproule@accenture.com

Geetika Rai
Financial Services, Marketing
+44 20 7844 5982
geetika.rai@accenture.com
Executive Summary

• Bespoke solutions to each financial and regulatory reporting demand or requirement have led investment banks to create a proliferation of systems, processes and workarounds which are expensive, labour-intensive, and suffer from information discrepancies.

• Tactical fixes have been the by-product of regulatory pressure, product innovation and acquisitions. The result is a number of challenges which must be addressed to improve information quality and speed of reporting.

• By establishing a consistent source of data and increasing transparency in the reporting process, investment banks have the opportunity to improve data quality, internal and external reporting and the ability to efficiently meet regulatory demands.

Background

The scale and pace of banking regulatory change is unprecedented. Banks must now respond to multiple regulatory regimes in multiple jurisdictions, in multiple stages of development with multiple implementation dates (many of which are often draft, with different implementation interpretations and subject to vested interests). The ability to execute against the regulatory change agenda will become a key determinant of high performance. Regulation implementation is no longer just ‘rule compliance’ – it’s about managing key constraints, about achieving high performance, and in some cases, competitive advantage. These regulatory requirements impact the business via the product mix, sustainable profitability and growth, managing within capital constraints, scenarios and stress testing. Treating regulatory compliance as a throw away or tactical cost of doing business is outdated. In the past, tactical fixes to known issues and changes to comply with new regulatory mandates have created complex and costly processes and systems.

The volume and pace of tactical change has meant that big picture themes have been neglected, such as data (the integrity, sourcing, completeness and cleanliness issues), process (lack of consistent end to end processes and clear hand-offs, leading to much rework) and controls effectiveness, and technology (fragmented and siloed IT systems). A lack of strategic solutions has typically resulted in no decrease (and maybe an increase) in the volume and extent of manual adjustments and workarounds prior to report generation.

Should financial institutions act now to take a sense check on financial reporting issues? Do they need to think about a joined-up approach to financial reporting with both the Front Office and Risk teams? Is there an industry best practice on financial reporting related change management that allows incremental changes whilst addressing the strategic integration issues?

This report analyses the fundamental issues at the heart of the financial reporting agenda and provides recommendations on various approaches to managing change going forward.
Finance departments need to respond rapidly to an evolving regulatory environment, in addition to resolving a variety of known current issues.

The large scale of regulatory change is forcing banks to look hard at the way they operate. The regulatory environment around capital and liquidity reporting, and the reporting of P&L and risk exposures is changing. The FSA and other EU regulators will expect to see improved transparency and better controls for managing the business within capital and liquidity constraints. The response to these regulations will require cross-divisional programmes. Banks will need to anticipate and plan more for the impacts of regulation, and find ways of creating solutions across CFO, CRO, COO, Treasury & CTO. Integrated data sourcing, trade, balance sheet & risk repositories, reporting & analytics will be a prerequisite of high performance.

There is broad consensus that Finance has, not only, to respond better to regulatory requests for transparency in financial reporting processes and compliance with key mandates, but also to improve business performance. But what are the “must haves” and “nice to haves” at this stage of financial evolution and should Finance think about the relative complexity of change to develop a robust change agenda? Finance have a number of key priorities and mandates that have to be addressed from a change perspective. IFRS conversion, Dodd-Frank, Basel III & EU/FSA liquidity rules are just some of the regulatory pressures which will drive decision making in the coming years.

Figure 1 shows the typical challenges around data sourcing, management & quality. Mastering data sourcing and data management requires a bank to address the challenges of integrating people, process and technology across the organisation to drive standardisation and actively govern data as an asset.
Key Data Management Challenges

People
- Incorrect level of sponsorship within the business
- No accountability for data quality issues into the business
- Changing organisational culture and embedding new responsibilities
- No coordinating of data services across the organisation
- No central decision making across siloed organisations
- No consistent communication and training

Process
- No consistent policies and standards across the organisation
- No process to drive consistent business definitions and quality rules
- No processes to drive data quality and fix errors as close to the source as possible
- No process for ongoing governance to monitor the use of policies and standards

Technology
- No standards for data communication
- No consistent application of business rules across interfaces
- Multiple technology platforms with no integration
- Siloed applications with multiple versions of the truth
- No consistent master data across the organisation
- Complexity of legacy estate
- Lack of documentation

Consequences of Ineffective Data Management

- Too much time spent on data quality and consistency checks rather than analysis and decision support
- Data for regulatory, risk management and ad-hoc purposes not timely available
- Inconsistent results
- Lack of transparency
- Inconsistent, partly overlapping data
- No central data quality standards and processes
- Keys and codes not unified
- Limited drill down/ across capabilities
- Inconsistent business rules
- Limited accessibility of data
- High manual intervention (adjustments, exceptions)
- Manual reconciliation
- Secondary analysis (spread sheet based)
- Complex, often aged environments with high maintenance cost
- Implementation of new requirements not sufficiently quick
- Dependability on key resources
- High spreadsheet dependency
- Loss of audit trails
- In ability to meet regulatory requirements

Source: Accenture Research 2011
1. Lack of common terminology
Financial reporting is often hindered by a lack of formalised and commonly understood business and accounting terminology between Finance and other functions. There is a risk that protracted time to resolve issues results in either an issue not being understood or getting lost in translation. As a consequence, financial reporting can remain unchallenged.

The introduction of a single book hierarchy with a single product taxonomy will begin to address this issue. Classifying data and making it widely known and understood in the organisation will ensure Finance and Risk are aligned with each other and with other areas of the bank.

2. Absence of consistent source of transactional data
Transactional data is often separated as it passes through the investment bank architecture. This is due to the belief that Finance, Risk and Operations communities need to process and adjust the same set of data so differently that each must have its own dataset. This forced divergence away from the consistent central source of transactional data is inefficient. Divergence of data brings with it people and process difficulties such as the need for duplication of effort and increased reconciliations. Once the data sets become segregated, significant time and effort needs to be invested by Finance, Risk and IT to ensure data integrity.

A consistent source of data must be accessed by Finance and Risk. This can be achieved by implementing a financial data warehouse with a strong data management policy ensuring data governance, quality, and security.

3. Absence of a single golden source of reference / static data
Systems must access a single source of reference/static data to ensure that the front and back office information is consistent. This golden source needs to be mandated and distributed for use in all data sets. The absence of a single transaction reference point currently means that when the financial control has a query, several layers of data need to be investigated before they can explain to Front Office teams what is being referred to. Add to this the transactional data separation point from above, and reconciliations become a labour intensive headache.

Individual reference data changes have a substantial impact on discrete reporting positions. A change to a single (major) counterparty can impact thousands of reporting positions referenced in many different local reports as the next illustration reflects.

Figure 2 shows an example of reference data flow.
Figure 2. Reference data flow example

Individual reference data changes can have a substantial impact on discrete reporting. A change to a single (major) counterparty can impact as many as thousands of reporting positions referenced in many different local reports. The below diagram is illustrative, but applies in equal measure to financial, regulatory, and credit risk reporting.

![Reference data flow example diagram]

Source: Accenture Research 2011

Figure 3. Month end adjustment analysis

<table>
<thead>
<tr>
<th>Root Cause Category</th>
<th>% of Hours to Process Adjustments</th>
<th>% of Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Price Verification</td>
<td>22%</td>
<td>3%</td>
</tr>
<tr>
<td>Structured Products Fair Value Option and Bank Debt Issuance</td>
<td>20%</td>
<td>9%</td>
</tr>
<tr>
<td>Inter-Entity</td>
<td>9%</td>
<td>20%</td>
</tr>
<tr>
<td>Settlement System</td>
<td>8%</td>
<td>9%</td>
</tr>
<tr>
<td>Local Accounting</td>
<td>5%</td>
<td>11%</td>
</tr>
<tr>
<td>Direct Expenses</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>P&amp;L Sharing Agreements</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>Monolines</td>
<td>4%</td>
<td>1%</td>
</tr>
<tr>
<td>System Feeds</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>Open Trades</td>
<td>2%</td>
<td>5%</td>
</tr>
<tr>
<td>Fair Value Historical Evaluation / FX</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td>Fees and Charges</td>
<td>1%</td>
<td>3%</td>
</tr>
<tr>
<td>Incorrect Trade Bookings Upstream</td>
<td>1%</td>
<td>3%</td>
</tr>
<tr>
<td>Data Quality</td>
<td>14%</td>
<td>19%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

80% of hours to process adjustments WD4+ accounted for by these 9 root causes

Nearly a fifth of adjustments relate to data quality issues

Source: Accenture Research 2011
4. Proliferation of manual adjustments
The complex nature of investment banking activity and the nature of IT investments to date, has led to large volumes of financial data being captured in multiple layers of silos. A significant increase in the number of manual adjustments is required to cleanse and correct data captured at source, perform calculations behind the scenes, and process top-side adjustments as a short term fix. This has created inefficiencies within Finance and has resulted in Finance not having the capacity to address the real source data/data transformation issues. This also questions control efficiency for both vanilla and complex exotic products.

Figure 3 shows a categorised summary of adjustments, derived from our experience working with a typical global investment bank.

5. Spreadsheet jungle
Most large investment banks suffer from an over-reliance on end-user developed spreadsheets. Controlling the growth of this local spreadsheet ‘jungle’ is a challenge from a data security, disaster recovery, and operational risk point of view. If Finance requirements are being met through these local solutions rather than requests for online systems, then IT as an enabler for financial reporting is questionable.

Figure 4 shows a high level view of the current state financial and regulatory reporting architecture in a typical investment bank. Currently, most investment banks experience a significant reliance on end-user developed applications, resulting in a lack of flexibility to change, unknown risks, and a weaker control environment.
Figure 4. High level current state financial and regulatory reporting overview

EUDAs = End User Developed Applications (spreadsheets)
RWA = Risk-Weighted Assets

Source: Accenture Research 2011
6. Inflexible legacy systems
Front Office IT solutions form a crucial part of the competitive advantage of an investment bank. But these systems must be properly supported and integrated into downstream financial reporting systems and processes to enable Finance to report at a product line, business or group level. Point solution limitations have meant that investment banks have long had to develop in-house proprietary solutions. This has meant that Finance IT architectures are far from becoming high performance or even adequate for current business needs.

7. Lack of standardised processes
Multiple products in multiple lines of business have led to many differing financial reporting processes. A lack of process standardisation and numerous process workarounds hinder end to end transparency of all business line data. This not only impacts the ability to close the financial books rapidly at month end, but also means the Finance transformation journey does not have a consistent start point.

Investment banks should first evaluate the processes being deployed to produce reports across different lines of business. By thoroughly reviewing existing processes and benchmarking against competitors, banks will be in a position to truly understand what changes need to be implemented. By taking this approach, tactical and strategic solutions can thoroughly be evaluated.

8. Single point of failure
The knowledge and experience of key Finance professionals, such as those in Product Control, Independent Pricing and Validation, or those in Finance Change with a comprehensive end to end overview has not always been harnessed in an efficient manner. These individuals have a comprehensive end-to-end overview of all front to back financial reporting processes, and not harnessing effectively has restricted the ability to achieve high performance.

Automating and standardising the processes, reducing the number of legacy systems, and implementing a golden source of data will limit the single point of failure quandary and reduce the dependency on key members of the team.
Financial reporting is often hindered by a lack of formalised and commonly understood business and accounting terminology between Finance and other functions. As a consequence, financial reporting can remain unchallenged.

9. Knowledge silos
Product silos within large investment banks have resulted in limited visibility and understanding of the cross product accounting treatment of business transactions. End to end finance data transparency is obscured, and management information is not always available on a timely basis.

By unifying the source of data across Finance and Risk, gatekeepers will have a clearer picture of the end to end process, and be empowered to produce value add commentary with little need to reconcile against other data sets. Information as a result will be produced in a more timely fashion.

10. Finance versus Risk
The Risk function often has independent trade and reference/static data feeds from the Front Office systems to those used by Finance. There is a risk that multiple versions of ‘truth’ prevail which can be problematic when dealing with regulators. The inability to align Finance and Risk on key requirements has meant that these functions have continued to extract, adjust, analyse and interpret trade data slightly differently. Inconsistencies in the sourcing and transformation of data have led to an increased volume of reconciliations, key person dependencies and discrepancies in reporting data internally and externally.

Figure 5 shows Finance & Risk data hierarchy requirements. The solution is to rationalise Finance and Risk architectures. A data warehouse would create a single source of data ensuring uniform reporting to stakeholders. By combining this solution with a robust data management policy, investment banks can ensure the abundant data available can be used to the best effect. This will allow more advanced analytics beyond standard financial reporting.
Consistency in Risk & Finance reporting requires that:

- book is at the lowest level of business hierarchy for the bank’s performance measure, part of the cost centre
- all other hierarchies are logical structures derived from foundation of positions, books, costs centres and valuations
- hierarchy is flexible to avoid misalignment of Risk and Finance
- contracts and positions capture data for all levels of hierarchy
- book to hierarchy is managed in one place.

Source: Accenture Research 2011
The challenges outlined in the previous section result in significant adverse impacts for Finance departments:

**Increase in cost base** – increase in Finance, operational and support headcount costs, which has the potential to alter the competitive advantage of the bank

**Trading volume caps** – volume limits are imposed for some new or exotic products because Finance need to manually support the downstream processing

**Limited value add** – Finance teams spend increased time on data cleansing and manual adjustments, rather than provision of value add P&L commentary and analysis for the traders they support

**Timeliness of data for trading decision** – reduced reliability and timeliness of data for the Front Office impedes trading decisions and can lead to sub-optimal balance sheet utilisation and hedging.

These challenges are very likely to:

**Hinder effective and efficient close processes** – delays to finalising the month end numbers, mean delays to insightful management information, which impacts successful delivery of strategy and timely visibility to the shareholders.

**Cause external body requests, which tie up CFO and first line reports** – increasing amounts of time is spent responding to regulatory bodies for supplementary information requests. This prevents Finance individuals from performing more value add activities.

**Result in a labour intensive Finance community** – from pre-banking crisis with very few requests, to post-crisis where requests seem to come in with very little notice and strict deadlines, there is pressure on CFOs to reprioritise resources to ensure compliance. Significant headcount numbers are required to resolve financial reporting issues before high value analysis can commence.

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Limit Finance's ability to react to change – quick fixes are often applied as a result of cost limitations and time requirements, rather than a more appropriate longer term strategic solution.

Lead the bank to lose out on potential profit-making opportunities: Poorly integrated systems and inconsistent information can result in protracted decision making. The additional time spent reconciling data and ensuring it is consistent results in time taken away from evaluating possible profit opportunities.

So what are the real implications for Finance?
Investment banks each have their own unique issues, but all operate in one of the most fast-paced, challenging and highly regulated environments. Therefore, transforming financial reporting is complex and requires the co-operation of many different areas in the bank.

Conclusion: Addressing the key challenges

Removing the need for Risk & Finance reconciliation
Most banks have separate groups responsible for the financial accounting and the general ledger versus market, liquidity and credit risk calculations and disclosures. In many cases these two groups get their overlapping data through different routes, and have different sign-off/adjustment processes. Consequently there is a huge operational effort to perform the monthly reconciliation between the two datasets.

The way to resolve this is to implement a single source of data for the two separate groups, utilising a single Risk and Finance data warehouse. To resolve the issue successfully, strong data management practices need to be implemented in conjunction with the new data warehouse. In addition, banks need well-managed transaction data and solid underpinning reference data.

Increasing transparency while reducing risk
Due to the large amount of product innovation and acquisitions activity over the past decade, many banks have been left with a complex web of interfaces into Finance. This makes the systems very expensive to maintain and change, and requires the Finance team to investigate breaks rather than doing value add analysis.

Reducing reliance on a large number of legacy up-stream systems, and implementing a single down-stream Risk & Finance data warehouse would allow banks to access information quickly and obtain detailed insight from this data. Coupled with strong data management, banks would be able to respond to increasing regulatory pressure to be able to track data back to the source and prove consistency between reports.

Increased workforce engagement in meeting regulatory requirements
With RWA becoming the scarce resource, it will likely become unacceptable for banks to only have a view of their official RWA numbers 4-6 weeks in arrears. They will need it daily. Reduced re-engineering efforts with sourcing data straight through would allow banks to move to daily P&L & RWA calculations. In addition, the workforce would become empowered to deliver value-add activities.

Accenture believes these recommendations will assist in addressing the key challenges in financial reporting. However, change is not easy. Transforming financial reporting is complex and requires the co-operation of many different areas of the bank, including Front Office trade capture, trade booking and valuation systems. In addition to systems change, it requires enhancement of Product Control, Finance & Risk processes to improve data quality used in financial processes and regulatory calculations.

By addressing these issues banks will be able to initiate cost take out, reduce manual involvement (and hence talent consumption), and increase pace, accuracy and consistency of information for decision makers. Any bank not addressing these issues will find the collective pressures will make their financial reporting too slow and inaccurate in this fast-paced environment.
Authors

Chris Wright
Senior Executive, Finance & Enterprise Performance
+44 20 7844 1711
Christopher.A.Wright@accenture.com

Jayne Fairhurst
Manager, Finance & Enterprise Performance
+44 20 7844 8850
Jayne.H.Fairhurst@accenture.com

Liz Percy
Senior Manager, Finance & Enterprise Performance
+44 20 7844 7033
Liz.Percy@accenture.com

Sridhar K Athreya
Manager, Financial Services, Risk Management
+44 20 7844 5503
Sridhar.K.Athreya@accenture.com
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