



JAMES GILL & C^o.

— SPREADSHEET RISK MANAGEMENT —

A Board-Room Guide To Spreadsheet Risk Management

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WHAT IS SPREADSHEET RISK?

Spreadsheets are ubiquitous in the modern corporate world. Largely owing to the computing power available on the desktop and the ease-of-use of spreadsheet applications such as Microsoft Excel, almost all business functions involve spreadsheets at some stage.

Spreadsheets therefore have a significant business impact in key areas, including:-

- ◆ Deal Evaluation, M&A and Flotations
- ◆ Performance Monitoring, Business Simulation, Budgeting and Forecasting
- ◆ Statutory and Management Financial Reporting

In many cases, key business and strategic decisions are influenced by the output from spreadsheets.

Greater analytical power on the desktop has increased the depth and comprehensiveness of business analysis, but it has also introduced a new risk – spreadsheet risk. Spreadsheet errors can adversely impact strategic decision-making, M&A decisions and, ultimately, affect shareholder value.

BUSINESS IMPACT OF SPREADSHEET RISK

The potential business impact of failing to manage spreadsheet risk can be understood by looking at a selection of recent high-profile examples in the public domain:-

ALLIED IRISH BANKS – 2002 - £434M

Fraud by John Rusnak at AIB's US subsidiary Allfirst was made possible by, amongst other things, falsifying spreadsheets used to monitor value at risk (VaR) and exchange rate data from Reuters. An independent report by the regulator criticised Allfirst's management practices and controls.

2003 – PROVIDENT FINANCIAL - \$70M

Provident's earnings for 1997 to 2002 included contributions from nine pools of car leases. In 2003 these earnings had to be restated by \$70m, partly owing to an error in a spreadsheet model calculating the debt amortisation. Provident now faces a class action suit from investors.

According to the CFO the analysts who built the model used for the first pool "put in the wrong value, and they didn't accrue enough interest expense over the deal term. The first model that was put together had the problem, and that got carried through the other eight."

2003 - FANNIE MAE - \$1.2BN

In October 2003, a fortnight after releasing Q3 earnings figures, Fannie Mae had to restate its unrealised gains by \$1.2 billion. This was the result of "honest mistakes made in a spreadsheet used in the implementation of a new accounting standard."

HOW LIKELY IS SPREADSHEET ERROR?

It is often assumed that spreadsheet error is something that happens to other companies. Many people claim that their own companies do not make mistakes in spreadsheets and that the examples above are one-off events.

Unfortunately, all the evidence suggests that spreadsheet error is disturbingly common. In the late 1990s, two independent surveys by KPMG and PwC found 'significant errors' in over 90% of the spreadsheets they audited. More systematic studies by HM Customs and Excise and the Mercer Group also show high levels of error.

With the increased size and complexity of modern spreadsheets, it is safe to assume that the level of errors remains roughly the same, at least in companies that do not actively manage spreadsheet risk.

WHY DO I CARE?

Although there has always been a risk associated with the use of spreadsheets, it is only now that this has become of direct concern at board level. Recent corporate scandals have led to regulatory and legislative changes which have brought the issue of spreadsheet risk forcibly into the boardroom.

SARBANES-OXLEY ACT 2002

The most extreme example is the Sarbanes-Oxley Act in the US. Whereas previously a misstating a companies earnings or financial performance through spreadsheet error would have been merely embarrassing, in the US this can now lead to litigation.

Every quarter, the board must now sign-off on the company's financial reporting procedures and controls. For most companies this is tantamount to vouching for the accuracy of their spreadsheets and auditors are now explicitly commenting on spreadsheet risk management.

A recent example is NASDAQ listed Tweeter Entertainment Group, Inc. (TWTR) which had errors in its November 2004 reporting. Deloitte & Touche, Tweeter's auditors, stated that controls relating to the accumulation of financial information resulted in a material weakness and deemed the company's monitoring controls over the use of spreadsheets to be ineffective, because the controls didn't detect errors in a timely fashion.

CORPORATE GOVERNANCE

Even in the UK, concerns over corporate governance, the Turnbull report and audit failures relating to Enron have led to a business climate in which it is no longer acceptable for boards to delegate responsibility for financial reporting. Specific regulatory measures have included:-

- ◆ Revisions to the Combined Code
- ◆ Launch of the new Financial Reporting Council (FRC)
- ◆ New proposals under the Operating and Financial Review (OFR)

Further revisions to the Listing Rules from the FSA are due by the end of 2004 and a new version of the Companies Act is expected in 2005.

Most seriously, the FRC has formed a committee to review the Turnbull report. This is being described as 'a radical new step' and may well introduce requirements similar to those in the Sarbanes-Oxley Act.

BASEL II CAPITAL ACCORD

Spreadsheet error and inadequate procedures and controls can also lead to a loss of competitive advantage. With the advent of the Basel II Capital Accord, those financial institutions which can satisfy the regulatory authorities that they have robust and advanced risk management procedures stand to benefit from reduced capital requirements.

The risk management of such institutions typically consists of measuring VaR for trading operations or credit risk for loan portfolios and almost always depends on spreadsheets at some stage. While some consulting firms are recommending that companies replace their existing spreadsheet systems, this is unlikely to work in practice.

A much less costly and, arguably, more effective option is to simply improve the robustness of existing spreadsheet systems. Hence, while boards do not need to be able to write their own spreadsheet models, they do need to understand spreadsheet risk and the sorts of controls and best practice that contribute to good Spreadsheet Risk Management (SRM™).

HOW CAN I MANAGE SPREADSHEET RISK?

Although it is difficult to insure against spreadsheet risk or mitigate the consequences, there are three things that can be done to reduce spreadsheet risk:-

POLICIES, PROCEDURES AND TRAINING

There is no great secret to increasing the reliability of spreadsheet models. It is largely a question of adapting known best practice to a particular company's business processes. Staff may need to be trained and there may be regulatory reasons to produce written spreadsheet policies and procedures.

TOOLS AND CONTROLS

One of the major contributors to spreadsheet risk is the lack of controls over versions and access. This leads to multiple copies of spreadsheets without accountability. A combination of procedural controls and appropriate software tools can virtually eliminate this problem.

There are also software tools designed to help with spreadsheet testing and auditing. These can greatly reduce the cost of spreadsheet testing and increase the reliability of the resulting models.

COMPANY CULTURE

The above measures will only be effective if supported by an appropriate company culture. It is all too common for employees to hide spreadsheet errors when they are discovered. Such a culture is ultimately counterproductive as, if no action is taken, the problem usually becomes worse.

HOW WE CAN HELP

JAMES GILL & C^o can provide advice on spreadsheet best practice, training for your staff and help draft written policies and procedures tailored to your organisation. We are also able to advise on the sorts of tools that may be appropriate for your needs.

For an initial exploratory discussion at no cost please contact us as shown on the back page of this document.

To make an enquiry or simply to ask whether we can provide a particular service, please call us, fax us or send us an e-mail.

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