ICAEW AUDIT & ASSURANCE FACULTY

Assurance over risk disclosures

THE JOURNEY: MILESTONE 2

ICAEW AND ASSURANCE SERVICES

All types of business, public and voluntary bodies, investors, governments, tax authorities, market regulators and their stakeholders need to be able to rely on credible information flows to make decisions. Confidence suffers when there is uncertainty about the integrity of information or its fitness for purpose.

ICAEW's Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

The *re:Assurance* thought leadership programme aims to:

- Find out where assurance services could strengthen markets and support economic confidence by making information flows more credible.
- Ask how the International Framework for Assurance Engagements can be applied and developed.
- Answer demands for practical guidance to meet emerging market needs.
- Share best practice examples and promote the high-quality assurance engagements already carried out by many ICAEW members.

WHAT ARE ASSURANCE SERVICES?

Assurance services are engagements in which an independent chartered accountant takes a close look at some specified business information, comparing it to agreed criteria. The accountant is then able to gather evidence to support a conclusion, which is provided in a written report.

The purpose of any assurance engagement is to build trust. When a chartered accountant signs an assurance report, they attach their reputation for expert knowledge and integrity. This makes the business information covered by the report more credible, and gives confidence to the people using that information.

To learn more about what assurance can do, take a look at the articles, guidance and reports on icaew.com/assurance or telephone Ruth Ward on +44 (0)20 7920 8639.

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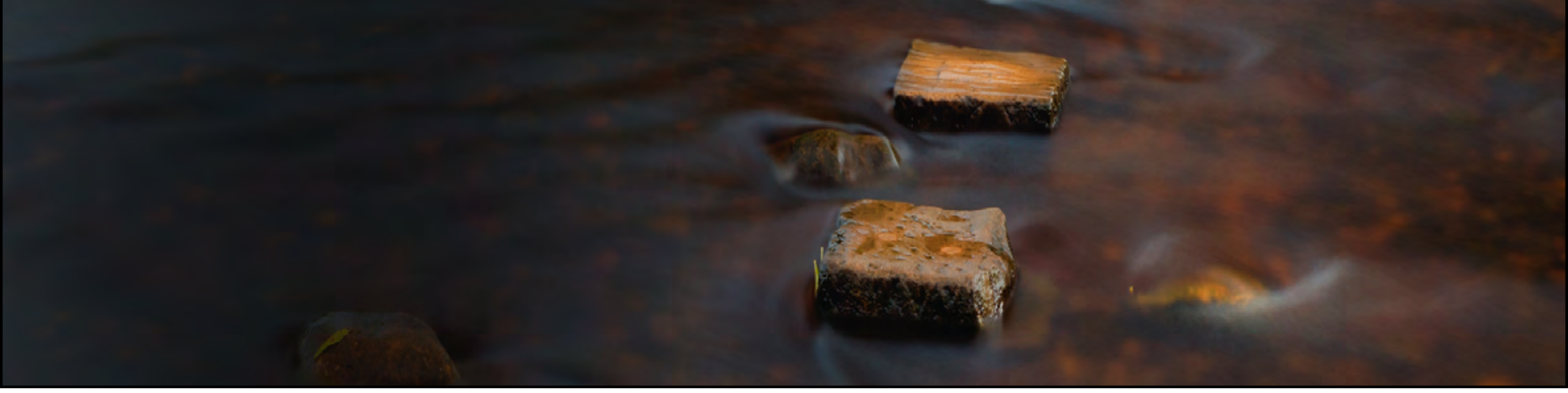


Introduction

It is now widely acknowledged that one of the central objectives of corporate reporting is to provide information relevant to users on the principal risks faced by a company and how these risks are managed. The impact of risk and risk management on a company's strategy is one of the key drivers of performance in a period, and of changes in value.

Accessible reporting of the relative success of planned risk management strategies provides an insight into the quality of stewardship exercised by the directors in the past and can enable an investor to form a view as to the range of likely outcomes in the future. More simply, it enables an investor to perform her own risk assessments.

Risk reporting is a product of a company's risk appetite, determined by the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives. The requirement for reporting should not, itself, drive the risk appetite. Some executives may suspect that when regulators and stakeholders ask for more detailed and more robust risk reporting they are in fact, asking for companies to take fewer, smaller risks. There is however, no reason that there should be correlation between the quality of risk reporting, together with the robustness of the process that produces it, and the sensitivity of the performance of the company to those risks.

Healthy capital markets should encompass companies operating across a spectrum of risk levels. Good corporate reporting enables investors to make informed choices about risk and return, and where on that spectrum to invest their capital.

1 ICAEW, Audit & Assurance Faculty, Narrative Assurance Working Party, "The Journey: Assuring all of the Annual Report?", 2013.

2 Financial Reporting Council "Guidance on Risk Management, Internal Control and Related Financial and Business Reporting" 2014.

3 ICAEW, Financial Reporting Faculty, "Reporting business risks: meeting expectations", 2011.

Background

This paper is the second Milestone in the series following *The Journey: Assuring all of the Annual Report?*[1], ICAEW's response to increasing demand for a higher degree of confidence over disclosures made in companies' annual reports. The Journey noted that, "There are many questions for an accountant looking to provide an assurance opinion over risk disclosures." This Milestone paper looks in more detail at some of these questions, proposes some practical approaches and seeks views on these from stakeholders.

In the wake of the financial crisis there were calls for improvements to risk reporting from a number of bodies including the Financial Stability Forum and the House of Commons Treasury Select Committee. The Financial Reporting Council responded to the Sharman Report by not only revising certain aspects of the Corporate Governance Code but also by revising and aggregating existing guidance on risk management into a new document: Guidance on Risk Management, Internal Control and Related Financial and Business Reporting[2].

If the importance placed by these government and regulatory bodies on risk reporting is indicative of the importance of credible risk reporting to other users of financial information, there would seem already to be a prima facie case for assurance on such enhanced risk reporting. However, on this stage of the journey from the auditor's current consistency check on narrative reporting in the Annual Report to an assurance opinion – in this case, over narrative risk disclosures, in whatever context these appear – there are a number of inherent difficulties to be overcome.

In 2011, ICAEW identified five key challenges to risk reporting[3] that would also be challenges for an assurance provider. These challenges include: the inherent unreliability of risk disclosures; the high cost and low perceived benefit; the temptation to default to generic disclosures that tell users what they already know; the subjective nature of reporting on the quality of risk management; and that management bias leads to the fact that some key risks – including the risk that management make bad decisions – will never be reported.

Without assurance and when the economic climate is favourable, the outcomes from good risk management look very similar to the outcomes from poor risk management. The damage caused by poor risk management will eventually become apparent, but in the short term investors will not have the information they need to understand and evaluate a company's risk management. Assurance brings a level of scrutiny which gives investors confidence. In an increasingly risky world, the stakes are high; the question of how to provide comfort over the quality of risk reporting should not be deferred as being too difficult .

The quality of the risk reporting versus the quality of the risk reporting process

The first question to address is whether the subject of the opinion should be the risk reporting process or the output of that process – the risk reporting itself. Either approach is possible in principle: assurance over the design and operating effectiveness of a set of systems and controls is possible as is assurance over the output of a set of systems and controls, for example financial statements.

As explained in *The Journey*, there are many questions for an accountant looking to provide an assurance opinion over the output – the risk disclosures themselves. Are the right risks included? Are enough risks disclosed? Or has the business disclosed too many risks, camouflaging a real source of concern? An assurance provider will need to have in mind what good risk reporting looks like in order to give an opinion; the user of that opinion will need to understand and share that perception of what good looks like. Is this feasible in relation to something as inherently subjective as risk reporting?

Unless directors, investors and assurance providers can agree on some specific, measurable objective qualities of good risk reporting, on what basis could the assurance provider ask the directors to amend the risk reporting?

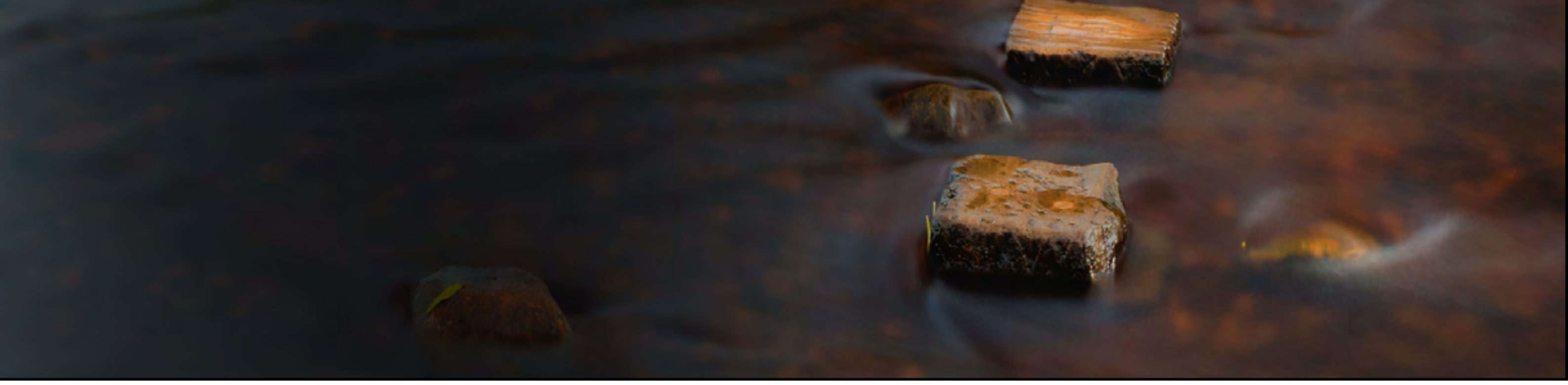
On the other hand, there are established precedents that could be used to agree measurable, objective qualities of:

- a fairly presented description of the risk report compilation process;
- well-designed and effective operating systems within that process;
- the breadth of stakeholder involvement in the risk identification and reporting process; and
- the responsiveness of executives and non-executives to risks identified.

These factors taken together increase the likelihood that a complete population of those risks that would affect investors' decisions, and the related risk management activities, are disclosed in a fair, balanced and understandable way.

If the purpose of risk assurance is to give investors confidence in a company's risk management, then assurance over the process of compiling the risk report may not only be more achievable but also more appropriate than assurance on the risk disclosures themselves.

It is assurance over a company's risk reporting process, rather than necessarily the output of that process, that allows a user of reporting to differentiate between a company with a robust approach to the identification, quantification, management and reporting of risks, and a company with a less reliable approach that is operating, for the time being, in a favourable wind.



What practical approaches are available for providing assurance over risk reporting?

Assurance opinion

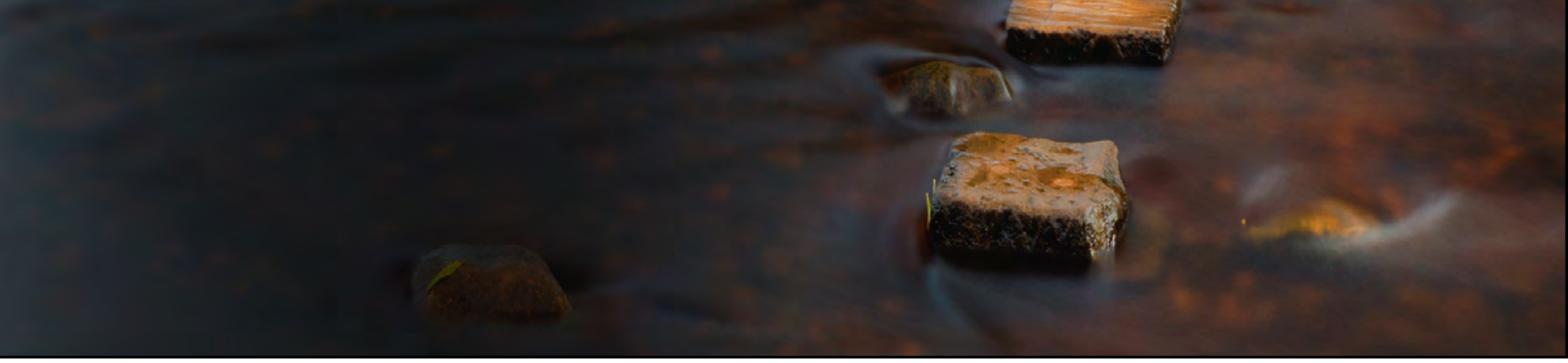
In order to form a view as to whether risk disclosures are properly prepared an assurance provider would need to make reference to a disclosed basis of preparation for those disclosures. This basis of preparation could stem from some externally imposed requirements, for example guidance from regulators, or it could be internally devised.

	Externally imposed	Internally devised
Advantages	Disclosures would be comparable. All entities are required to follow the same process and make disclosures intended to address the same requirements. If consensus is reached as to the usefulness of certain disclosures these could be mandated on a sector basis.	Management can determine what process and reporting is most appropriate for the company. Allows greater flexibility to devise an integrated approach to disclosure which makes the link between risks and how they are managed, and performance for the period.
Disadvantages	Companies differ in size, complexity and risk appetite; a basis of preparation suitable for the largest, most complex and riskiest will be overkill for a smaller, simpler, and more risk averse business potentially leads to boilerplate disclosures. Companies would need to disclose how they had applied the external requirements to their circumstances including what judgements had been made. This essentially results in an internally developed basis of preparation, though with a core similarity to peers.	Assurance provider must first assess the suitability of the basis of preparation. Will compliance with the disclosed basis result in reporting that is meaningful to users and not misleading?

In either case, the basis of preparation would need to be available to the users of the reporting. The assurance procedures could include evaluating:

- The design and operating effectiveness of the systems, procedures and practices put in place to identify, quantify and report risks and to devise, assess, approve and report risk management strategies.
- The design and operating effectiveness of the process to collate and organise risk and risk management information to give a materially complete, fair and balanced view of the risks affecting the future operations of the business.
- The mechanisms put in place to monitor compliance and test for non-compliance with risk management policies.
- The sufficiency of the depth and breadth of participation by stakeholders in forecasting and risk-management.
- The governance arrangements including the reporting of events and status to those charged with relevant responsibilities, such as the head of risk, the audit committee and the board of directors and their responsiveness to risks identified.
- The completeness and accuracy of quantitative information, including out-turn in the period against risks forecast in previous periods, and the fairness, balance and understandability of qualitative information disclosed.
- The quality and supportability of disclosures linking risks and how they were managed in the period, to performance in the period and linking forecast risks and risk management strategies with expected future performance and growth in value.

Of course, the assurance provider would use judgement and a degree of guidance to decide how much work is needed to support the level of assurance provided and the chosen form of opinion.



Professional views

We should not, however, presume that the only way in which a chartered accountant can add credibility to risk disclosures is through provision of a formal assurance opinion. Auditors already read the narrative reporting, including risk disclosures in an Annual Report, and would be required to report by exception if anything came to their attention which indicated that the directors' fair, balanced and understandable conclusion on the Annual Report was not consistent with the knowledge the auditor had acquired in the course of the audit.

In practice, even in the absence of any regulatory requirements and formal professional standards, auditors already challenge executives, as well as reporting their views to non-executives, on these disclosures, on the processes that go into compiling them, and, where this is within the auditor's sphere of expertise, the risk management strategies in place. This might include the auditor's views on: the degree of consistency between reported risks and those risks that in practice receive the greatest amount of consideration by the Board; the fairness of the description of the effectiveness of risk mitigation strategies; and the extent to which risk reporting covers risks affecting all resources, not only financial resources.

Auditors develop a broad and deep understanding of their clients' businesses and are, therefore, in a good position to provide critical challenge to boards on the quality of both risk disclosures themselves and the processes used to compile these.

In providing this challenge, the auditor is acting on behalf of the investor and it seems reasonable to ask both:

- Whether the scope of such challenge is in line with investors' expectations; and
- How best the scope of work and the professional views formed as a result of this critique can be shared with investors, if they would be considered valuable.

Accountants could develop a consistent approach to the scope of work and resulting views based on a consensus as to the principles of good risk reporting. The seven principles suggested by ICAEW in *Reporting business risks: meeting expectations* could provide the starting point for debate leading to consensus on how best to structure professional views that are not formal assurance opinions – on risk reporting.

Seven principles for better risk reporting

- tell users what they need to know
- focus on quantitative information
- integrate into other disclosures
- think beyond the annual reporting cycle
- keep lists of principal risks short
- highlight current concerns; and
- report on risk experience

Summary

In broad terms, the possibilities are:

- Assurance opinions, based on an externally imposed framework which could potentially provide criteria for a fair, balanced and understandable opinion.
- Assurance opinions, based on frameworks devised by companies themselves, most likely resulting in a "properly prepared" opinion; or
- Professional views on the quality of risk reporting included as narrative in a long-form report, which could, for listed companies, be part of the new long-form audit report.

What's your view? Should regulation impose a requirement or should any solution be market-driven? If the latter, which way will investors and other stakeholders want to go?

Please share your views with us by email or on twitter.
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