FINANCIAL REPORTING FACULTY

RISK REPORTING: PRINCIPLES FOR BETTER PRACTICE

A BRIEFING PAPER

INFORMATION FOR BETTER MARKETS INITIATIVE

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An underlying cause of the recent financial crisis was a severe failure in risk assessment – by financial institutions, regulators and investors. Major risks were underestimated or ignored, and so they were managed either badly or not at all.

This has led to growing demands since the crisis for better risk reporting in the hope that it will encourage improvements in both risk assessment and risk management, and so make future crises less likely. Such demands have not been aimed only at the financial sector, but have extended to public companies in all sectors.

Yet in many countries, including the EU and the US, risk reporting requirements have been in place for some years. So why was risk reporting before the crisis apparently inadequate in spite of these requirements? And what can be done about it?

A new report from the ICAEW Financial Reporting Faculty, *Reporting Business Risks: Meeting Expectations*, explores these issues, looks at what lessons can be learnt from the crisis, and suggests some principles for how risk reporting can be improved in practice. This work follows up the ICAEW Financial Services Faculty's 2010 report, *Audit of Banks: Lessons from the Crisis*.

Reporting Business Risks sets out seven principles for better risk reporting. These are practical ideas for how risk reporting can be improved:

- **Tell users what they need to know.** Users of corporate reporting want information about a company's risks so that they can make their own assessment of risk. Companies should focus on this objective in deciding what to disclose. As the Financial Reporting Council (FRC) points out in its recent report, *Effective Company Stewardship: Next Steps*: 'The company is best placed to know what users of annual reports and financial statements are interested in – because it is the board of directors and management that have direct contact with investors, analysts and other users of the annual report and the financial statements.'
- **Focus on quantitative information.** Disclosing more detailed analyses of the quantitative data that firms already provide would give helpful new information. Too much weight has been placed on the production of descriptive risk lists. This is not a call for quantification of risks, which usually involves dubious assumptions about the probability of future events. Nor is it a call for qualitative information to be neglected. What we have in mind is more information on the breakdown of firms' activities, geographically and by sector, and on their assets, liabilities and commitments.
- **As far as possible, integrate information on risk with other disclosures.** Financial reporting provides much information on risks already, and this should be integrated with other risk disclosures. But information on risk should also be integrated with firms' descriptions of their business models, their forward-looking disclosures, their discussion of past performance, and their financial reporting. A firm's risks are usually inherent in its business model, so explaining the business model should involve explaining its risks. Risk is forward-looking and cannot be fully understood except in the context of broader forward-looking information about a firm's performance, plans and prospects.
- **Think beyond the annual reporting cycle.** Many risks stay the same from one year to the next. Others are highly variable and information on them needs to be updated more frequently than once a year. The internet, rather than the annual report, would probably be the right place for information on both sorts of risk. Both the FRC report *Effective Company Stewardship* and the Accounting Standards Board report *Cutting Clutter: Combating Clutter in Annual Reports* draw attention to the possibilities of reporting information on the internet rather than in the annual report. Risk reporting could be a prime candidate for this approach.

- **Where possible, keep lists of principal risks short.** Users are currently faced with long and indigestible risk lists that are all too easy to ignore. Shorter lists would make it easier for them to understand what really matters. But where it is useful for companies to disclose other risks as well as those identified as the principal ones, they should still do so.
- **Highlight current concerns.** It is likely to be of interest to users to know what risks are currently most discussed within a firm. This approach has the advantage that what is being currently discussed is objectively verifiable – from internal agenda papers, for example. The concerns identified in this way will often be different from the firm's principal risks, and disclosing them could give users a valuable insight into the business.
- **Review risk experience.** Companies could usefully review their experience of risk in the reporting period. What went wrong? What lessons have been learnt? How do their experiences match up with the risks that they had previously reported? It would have been informative, for example, to read what lessons about their own risk management financial institutions learnt from the financial crisis.

Companies that follow these principles should be able to improve their risk reporting in practice.

But *Reporting Business Risks* warns that users of business reports need to have realistic expectations for how much risk reporting can ever achieve. In a competitive economy business failures are inevitable, and it would be unreasonable to expect risk reporting to provide a reliable early warning of which businesses are most likely to fail – still less to prevent their failure. With the benefit of hindsight, people often wonder why firms do not foresee problems ahead and they tend to forget that the future is always full of unknowns, including 'unknown unknowns'.

In *Reporting Business Risks* we review relevant academic research of the past 20 years from Europe and North America. Based on this evidence, we identify five main reasons why actual risk reporting has proved to be less useful than many had hoped:

- It is impossible to know even after the event whether most qualitative, and some quantitative, risk reporting is accurate or inaccurate. This must limit the reliance that users can place on it.
- There are often competitive costs to informative risk disclosures and they also have potential costs for managers. These costs may exceed the perceived benefits of risk reporting, leading to uninformative disclosures. Indeed, risk reporting creates its own risks and so needs to be undertaken by preparers, and interpreted by users, as an exercise in risk management.
- It may well be appropriate to comply with requirements to report key risks by making generic disclosures, even though they will be seen as boilerplate.
- The effectiveness of a firm's risk management depends on the quality of its managers, and this is something that statements of the company's attitude to risk and disclosures of internal structures and procedures are unlikely to reveal.
- There are some risks that firms will never report and others that they are always liable to understate.

It is partly for these reasons that our recommendations for better risk reporting are expressed as principles and not as proposals for new, tougher requirements. The evidence suggests that because of the subjective nature of risk, risk reporting requirements often have only limited effectiveness. The quality of risk reporting – even under a mandatory regime – is to a large extent voluntary. So in important respects risk reporting will only improve if those involved really want it to.

Reporting Business Risks: Meeting Expectations can be downloaded as a PDF from icaew.com/bettermarkets.

For printed copies, email bettermarkets@icaew.com.

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