Five pitfalls to the principles of risk reporting, and six steps around them

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Curious isn't it? In a downward spiral of fear, price volatility and over-reaction, with increased investor scepticism, many companies simply aren't giving real insight to their shareholders about the risks they face?

It is hard to find any company that does not say that it complies with the risk management requirements of the Combined Code. It is nearly as hard to find a company that is prepared to actually demonstrate that compliance beyond the legal requirement or, indeed, to go as far as that.

Some thoughts…

In the current climate, 'sentiment' is playing a more significant role than it does in a bull market, and nowhere is this more apparent than in the 'fundamentals'.

Professional investors and their advisers often find that the risk discussion is of little use to them, being pro forma and boilerplate driven, and often too simplistic, whereas other users find the disclosure too complex and overwhelming. The trick here is to get the balance right, starting from scratch, and build the risk discussion into a coherent, narrative whole. The reluctance of companies to disclose risk information was well put by one analyst, who said, "You always have to drag these statements out of IR people and it's always like pulling teeth".

Douglas Flint, Group FD, HSBC, caught the mood of the moment when he said: "Any responsible management team would disclose information beyond that which is technically required if it gave greater clarity to a matter of interest or concern to stakeholders, because greater clarity brings confidence and confidence brings a higher market rating."

In October last year, Bill Knight, Chairman of the Financial Reporting Review Panel, said: "The Panel is less likely to question directors whose business model is clear, who avoid boiler-plate descriptions and who are open and direct about the specific risks and uncertainties that may challenge their business in the foreseeable future."

And, at a recent seminar, Anthony Carey of Mazars and the FRRP stated: "The Principal risk discussion in the EBR is one of the benchmarks used to get an insight into how well the business is being managed."

So what are the problems in reporting principal risks? We have identified five common, interlinked pitfalls stopping companies from getting this confidence, immunity and insight. We've called them:

Kitchen sinking, hedging, groundhogging, positioning and limiting.

Five pitfalls…

1. The kitchen sink

Until recently, the reporting of risk, if it was done at all, seemed to be focused on a perceived need to declare any and all conceivable risks, in the American style. This remains so in many cases, leading to long lists with many potential, unprioritised and often generic, risks – the proverbial kitchen sink approach.

This style of reporting has a close sibling, which is the list generated and signed off the last time a prospectus was issued by the reporting company.

Both are easily identified; they are text-led, run over many pages and usually each risk has an opening sentence or title highlighted in some way, with a couple of paragraphs of subsequent narrative.

And both miss the point, as they are designed and phrased to highlight the risks a potential shareholder may face to their investment, rather than the risks the company faces to its achieving its strategy and delivering value. We believe that this is a critically important distinction that is not often understood.

The point of the discussion of the principal risks facing a company is exactly that, the risks facing the company, which may not be the same as for others in the same sector. Most investors and their influencers know the generic or sector-wide risks, or they wouldn't be doing what they do – what they value is the insight of the specific.

2. Hedging bets

Many Principal Risk sections come hedged around with so many Rumsfieldlike caveats you have to wonder if they are worth the paper they are printed on. These caveats are often placed at the start of the section, can run for up to two or three paragraphs and call into question the relevance and validity of all that follows. No other part of the business review is presented in such a way, so maybe the cause is the derivation or provenance, as described above, of the risk element from its presentation in other circumstances, and then being repurposed for the Annual Report.

Here it is in all its glory: 'The following describes some of the risks that could affect x. There may be additional risks unknown to x and other risks, currently believed to be immaterial, which could turn out to be material. These risks, whether they materialise individually or simultaneously, could significantly affect the Group's business and financial results.'

The other favourite caveat is focused on how the presented risks are prioritised, in that 'these are not presented in order of importance', or that 'these are presented in alphabetical order'. This seems slightly ridiculous if the company concerned has identified them as the principal risks, making the point that a hierarchy exists as other risks are already considered to be less than principal.

Five pitfalls… continued

What's more, nearly half of the companies in the FTSE100 seem reluctant to use the word 'Principal' in identifying their risks, with a quarter just describing 'Risks' and the rest using various phrases, such as 'Key', 'Material', 'Most important', 'major', and 'Important and significant'.

You wouldn't write 'Don't blame us, we haven't a clue' on the cover, why do it for a critical section of the document seen as a benchmark for management?

3. A copper-bottomed, boilerplated Groundhog

You could call it 'good enough last year, so good enough this'. It is not clear precisely what drives this particular approach. Fear? Idleness? Ignorance? Which ever it is, the approach manifests itself in never-changing copy. One has to wonder if the company exists in the real world. There are some stunning specimens to be found this year – the principal risks facing some companies at the start of 2009 are exactly the same as those they faced at the start of 2008, to the extent that one report is a facsimile of the other. Either these companies have a magic looking glass… …or not. And the consequent investor's conclusion is?

4. Positioning tells you a lot about priorities…

Companies present risk information in more than one place – the majority present their Principal Risks, or the whole risk register, within the body of the business review/OFR, and then have the compliance information within the Corporate Governance section; further discussion can often be found in the Finance Director's Report and in the Notes to the Accounts.

Curiously, many of the Risk sections are placed well back in the narrative section, divorced from the discussion on strategy and the marketplace. Some are contained wholly within the Financial Review, or even buried entirely within the Corporate Governance Report, which are both curious places to cover strategic and operational material of this kind. One company even had it as the very last piece of information presented within the document. Nearly 60% of Reports identify a Risk section in the Contents, with over 5% not doing so in the main Contents but in a sub-contents at the start of a Business Review or Governance section. The rest have no navigation to their Risk discussion at all…

What message does the audience take away if important information is presented as low priority and hard to find?

Five pitfalls... continued

5. Limiting tells you a lot about priorities too

The requirement of the Companies Act 2006 is that the Enhanced Business Review should provide a description of the principal risks and uncertainties facing the company. That is all, no impact, no mitigation. It is, however, recognised as best practice to provide both these pieces of information – and the FRRP has also suggested that they should be provided.

Many companies do this, to a greater or lesser extent, but a few do not, citing commercial confidentiality or sticking on a clause like this to the rest of their caveats: 'The following highlight the Group's exposure to risk without explaining how these exposures are managed and mitigated or how some risks are also potential opportunities'.

The final way of limiting risk disclosure is to focus solely on financial risk, which rather misses the point.

From an audience point of view this is marginally better than hedging, as at least there is an awareness of the risk, even though the company may appear clueless about what to do about it.

Six steps to heaven

From a best practice point of view, there are a number of points to cover – it is notable that, under Turnbull, the Board's deliberations should cover information on extent, likelihood and mitigation – presentation of which forms the basis of best practice reporting and, if it has been considered as is required, should be available for disclosure. This brings us back to Douglas Flint's point, set out at the beginning of this paper, "Greater clarity brings confidence and confidence brings a higher market rating."

1. Presentation

a. Disclose, but don't overstate – give quantification, graphs, case studies and commentary.

b. Use judgement to strike the right balance between too few and too many. If 'non-principal' risks need to be discussed, these can accompany the primary disclosure

c. Summarise and be clear and easy to understand. Seven pages of dense type sends all kinds of bad messages.

d. About 35% of companies use more than body copy in their Risk discussion, and most of these use tables to set out a risk/impact/mitigation matrix.

e. It is possible to keep the discussion short, although a really short version tends to lose out as it does not have room for covering identification, quantification and illustration; however, the creative use of cross-referencing can help with this.

f. In the FTSE100, companies typically identify some 12 principal risks. The range is four to 28, with a reasonable upper limit of about 10-15. This ignores the banks which have much more extensive disclosure, as risk is core to their business, although some seem to have struggled a bit with the whole concept of reporting on principal risks.

g. In terms of space used within the report, the range devoted to the discussion of risk, beyond that stipulated by the Combined Code in the Corporate Governance section, is half to nine pages, with an average of about two and a half.

h. If you must have caveats, put them at the end, please!

Six steps to heaven continued

2. Identification

a. Provide context, with explicit identification of the principal risks, explanation of prioritisation and how this was achieved. The use of a likelihood/impact matrix achieves this at a glance (published examples are very rare, none of the FTSE100 do this, although many refer to it as a technique).

b. Assessment should be made of the overall risk profile, not just financial.

   i Areas to consider include: Acquisitions, Competition, Exterior/marketplace, Financial, Hazard, Operational, Pensions, Reputational/CR, Strategic, Other.

   ii Attention should be given to company/industry specific risks, as well as the more generic.

   iii Upside and downside – an appropriate response may present an opportunity to enhance value.

c. Up-to-date – The risks discussed should pertain to the period under review (bearing in mind the need to achieve a forward-looking orientation), and the timeframe should include both short and long term horizons – the risk profile can change through the year, so a Half Year Report may be different to the ones on either side. Examples of possible risks applicable in the 2009 reporting round that were not top of the pile in 2008 are, among others: access to funding, risk of counterparty bad debt, impact of recessionary marketplace, share price, dividend and pension considerations.

3. Integration

a. Clear links from the principal risks to the strategic priorities, key resources and business segments of the company. This can be achieved by placing the risk discussion in or near the strategic discussion, rather than burying it.

b. Alignment to KPIs – logic dictates that a principal risk threatens key performance.

c. Check alignment with assertions made elsewhere in the report (eg marketplace, future, strategy, resources, governance).

4. Quantification

a. Provide quantitative evidence to support all of the above and allow an understanding of relative importance to be developed.

b. Points to cover include magnitude, impact, likelihood, materiality, sensitivity analysis

c. Examples of quantification of Principal Risks are very hard to find – among the FTSE100 only three present any sort of sensitivity analysis, and none presents a likelihood/impact matrix.

Six steps to heaven continued

5. Mitigation

a. Explain how the principal risks are monitored and managed and mitigated, with a distinction made between those that can be controlled, and those that cannot.

b. Skills, processes and policies – Board ownership of each risk.

6. Illustration

a. The Turnbull requirements around embedding in culture and quick response suggest the use of case studies, to illuminate and confirm these aspects of the company's approach to risk, would be appropriate.

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