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The role of disclosure in risk assessment and enhancing the usefulness of corporate reporting in decision-making

Note by the UNCTAD secretariat

Executive summary

This background note has been prepared by the UNCTAD secretariat to facilitate deliberations at the thirty-fourth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting on the role of disclosure in risk assessment and enhancing the usefulness of corporate reporting in decision-making. It discusses the importance of information disclosure for investment-related decision-making and highlights key issues related to risk disclosure in corporate reports.

The note discusses the main risks relevant to decision-making and the current risk disclosure practices of companies. The main concerns of users of corporate reports are the following: disclosures are dispersed throughout reports, often without links to potential financial impacts; disclosures vary in quantity and quality; disclosures often use generic language; and disclosures lack focus on material risks. In addition, preparers of reports face problems related to measurement and materiality, indirect costs and trade-offs between transparency and confidentiality.

The note presents the recent work of international standard setters that have proposed guiding principles for good practices in risk disclosure. Drawing on insights from existing good practices and academic studies, the note makes suggestions for enhancing the usefulness of risk disclosure and highlights issues for discussion.

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I. Introduction and background

1. The disclosure of high-quality information is critical for effective decision-making by investors and other stakeholders. Companies provide information through various mandated and voluntary means. Mandated disclosures include financial reports and other regulatory filings, while voluntary disclosures are those made in addition to disclosures mandated by regulations, such as investor presentations and other ad hoc disclosures. Corporate information disclosure is not only vital for the functioning of efficient capital markets but also provides a wider audience beyond investors, such as Governments, employees and other stakeholders, with information that is useful for assessing stewardship and making economic and policy decisions.

2. The demand for corporate disclosures arises from the challenge faced in all economies, to optimally allocate resources to investment opportunities. This challenge is compounded by the fact that company insiders, such as managers and entrepreneurs, typically possess superior information about the profitability of investments a company has made and often have conflicting incentives with those of the providers of capital. Reliable and relevant information enables capital providers to assess, ex ante, potential investment opportunities and to monitor, ex post, the use of their capital once committed to funding productive investments by companies. Capital markets are thus only able to achieve their role in the efficient allocation of capital if credible mechanisms are created to mitigate agency and information problems between corporate insiders and capital providers.

3. Well-functioning capital markets and the efficient allocation of risk capital are vital for long-term economic growth. Corporate disclosures are therefore not only important for stock markets, but also provide financial intermediaries such as banks with the necessary information to supply debt capital to the economy. Overall, the reduction of information asymmetries through transparency enhances financial stability.[1] Furthermore, corporate disclosures may facilitate the measurement and management of indicators important for achieving the Sustainable Development Goals.

4. Disclosure requirements for mandated financial reports are typically set out in national legislation, stock exchange listing rules, national generally accepted accounting principles and the International Financial Reporting Standards issued by the International Accounting Standards Board of the International Financial Reporting Standards Foundation for general purpose financial reporting by listed companies. The objectives of financial reporting are to provide financial information to equity and debt capital providers useful in decision-making.[2] In a survey and discussion forum of preparers and users of financial reports hosted by the International Accounting Standards Board, over 80 per cent of respondents stated that the current disclosure environment required improvement.[3] Investors have expressed concern over not receiving enough relevant information and the fact that reports contain immaterial information and generic language. Conversely, preparers of financial reports have emphasized that they must address ever-expanding mandatory disclosure requirements and investor-driven demands for greater voluntary transparency. Moreover, a significant regulatory burden on preparers has resulted in the perception of reports as compliance documents rather than a means of communication. In this regard, academic research suggests that the relevance of accounting

[1] Enhanced Disclosure Task Force, 2012, Enhancing the risk disclosures of banks, available at http://www.fsb.org/2012/10/r_121029/.
Note: All websites referred to in footnotes were accessed in April 2017.

[2] International Accounting Standards Board, 2015, *Conceptual Framework for Financial Reporting* (International Financial Reporting Standards Foundation, London).

[3] International Accounting Standards Board, 2013, Feedback on survey and discussion forum, Agenda Paper 3I, available at http://archive.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Board-Discussions-Current-Stage-CF.aspx.

information, such as reported earnings, for investment-related decision-making has diminished over time.[4]

5. Pressure on companies to voluntarily provide more frequent disclosures, such as quarterly earnings guidance, has led to the view that equity markets have become too focused on short-term results and less effective in promoting long-term investments and innovation and, as a result, companies have become focused on delivering short-term results, potentially at the expense of their long-term viability.[5] The financial crisis in 2008 underscored that the short-term focus of companies can lead to the underestimation or neglect of long-term risks; such risks are therefore not adequately disclosed to investors.

6. Investor demand for greater transparency includes increasing requests for the disclosure of non-financial information, such as environmental, social and governance data. Central to this demand is the argument that the disclosure of such data improves the ability of investors to evaluate and understand a company's long-term risks and that it is therefore relevant to investment-related decision-making.[6] For example, the Task Force on Climate-Related Financial Disclosures established by the Financial Stability Board has issued recommendations for the voluntary disclosure of climate-related risk, stating that "without effective disclosure of these risks, the financial impacts of climate change may not be correctly priced".[7]

7. This background note aims to facilitate discussions at the thirty-fourth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting on the role of disclosure in risk assessment. It highlights the function of corporate disclosure in capital markets, summarizes the current status of risk reporting and outlines the main issues related to risk disclosure in corporate reporting under prevailing frameworks and standards, including factors that have contributed to the decline in the usefulness of corporate reporting for decision-making. The note presents issues for discussion and provides some initial suggestions on how to enhance the usefulness of corporate reporting for risk assessment and decision-making, including the optimal allocation of resources to alternative investment opportunities.

II. Current status of corporate reporting and role of disclosure in risk assessment

A. Definitions

8. Corporate disclosure comprises the communication of information by corporate insiders, such as management and entrepreneurs, to stakeholders of a company. The main audience is equity and debt capital providers, but also includes other stakeholders such as policymakers, regulatory bodies, tax authorities, employees and general society.

9. Certain types of disclosures are mandated and others are voluntary. Mandated disclosures include financial reports whose extent and comprehensiveness in part depends on whether the disclosing company is listed on a stock exchange and on the size of its listing. Financial reports of listed companies typically must adhere to national reporting

[4] DW Collins, EL Maydew and IS Weiss, 1997, Changes in the value-relevance of earnings and book values over the past forty years, *Journal of Accounting and Economics*, 24(1):39–67; ME Barth, K Li and CG McClure, 2017, Evolution in value relevance of accounting information, Working Paper 3512, Stanford Graduate School of Business.

[5] J Kay, 2012, The Kay review of United Kingdom [of Great Britain and Northern Ireland] equity markets and long-term decision-making, Final report, available at https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making.

[6] Task Force on Climate-Related Financial Disclosures, 2016, Recommendations of the Task Force on Climate-related Financial Disclosures, available at https://www.fsb-tcfd.org/publications/.

[7] Ibid.

standards or those of the International Accounting Standards Board.[8] Listed companies are usually also required to make ad hoc disclosures of material events, director share purchases and sales and other information relevant to investment-related decision-making. Although requirements vary by country, mandated reports generally comprise financial statements with footnotes and director-level, management and corporate governance reports.

10. The objectives of financial reporting and characteristics of useful financial information under the International Financial Reporting Standards are provided in the conceptual framework of the International Accounting Standards Board, which states that the objective of general purpose financial reporting is to provide information "that is useful to existing and potential investors, lenders and other creditors in making decisions".[9] To be useful to investors in this regard, disclosed information must fulfil the fundamental qualitative characteristics of relevance, that is making a difference to a decision, and of reliability, that is constituting a faithful representation of economic reality. Central to the mandatory disclosure of information is the concept of materiality. Information is considered material if "omitting it or misstating it could influence decisions" by investors.[10]

11. In addition to regulated mandatory reports, voluntary disclosures have become an important, frequent way for companies to inform capital markets of financial performance and communicate the stewardship of available resources. The means of such disclosure include conference calls, investor presentations, management forecasts, sustainability reports and online earnings guidance and information sharing. In recent years, a growing number of companies have voluntarily disclosed information on environmental footprints, social policies and governance. Even if not required to do so, companies often elect to report information that is useful in assessing their future prospects, to avoid being perceived as hiding unfavourable information and to differentiate themselves from less well managed companies in the competition for capital. Disclosing information can be costly, however, and companies thus disclose private information only when the perceived benefits exceed the associated direct and indirect costs of disclosure. Many countries have also adopted quasi-mandatory corporate governance codes, often with provisions on compliance or explanation.

B. Assessing risk exposure

12. Risk measurement plays a central role in capital allocation decisions; investors allocate capital to investment opportunities that provide the highest expected return for a given level of risk. Access to information is thus critical for investors to assess the expected risk and return of investment opportunities and make investment decisions. In well-functioning and efficient capital markets, prices serve as reliable signals for the allocation of economic resources. Better information leads to lower levels of uncertainty and more efficient allocations of capital that supports economic growth.[11]

13. Investment risk refers to the variability of expected returns from an investment. For equity investors, risk is associated with uncertainty in the realization of stock returns and potential losses, and for lenders, risk is associated with the inability of a borrower to make interest and capital payments. Investment returns are, in turn, determined by expectations of the economic performance of the underlying productive asset, that is the business, and the future cash flows it can generate discounted by the opportunity cost of capital. Risk affects both the variability of future cash flows and the cost of capital. Risk is often distinguished from uncertainty; the former is assumed to be measurable through

[8] The International Financial Reporting Standards are required or permitted accounting standards for listed companies in more than 100 countries worldwide. For a list of countries, see http://www.ifrs.org/use-around-the-world/why-global-accounting-standards/.

[9] International Accounting Standards Board, 2015.

[10] Ibid.

[11] See for example R Lambert, C Leuz and RE Verrecchia, 2007, Accounting information, disclosure and the cost of capital, *Journal of Accounting Research*, 45(2):385–420.

objective or subjective assignments of statistical probabilities to outcomes and the latter refers to potential outcomes for which no such probabilities exist.[12]

14. The economic performance of companies is affected by a variety of risks, distinguished as business, financial and non-financial risks. There are no common definitions of risks that affect businesses, although most categorizations generally cover the same types of risks. Companies are exposed to specific risks through the nature of the uncertainties surrounding their business activities.

15. Business risk refers to the variability of profits stemming from changes in customer preferences, competition, counterparties, technological or socioeconomic factors and other factors specific to the business model and products or services, such as the human capital, intellectual property, product quality and liability, of a company.

16. Financial risks include the following:

(a) Solvency (bankruptcy), or the potential inability of a company to meet its long-term financial obligations such as interest payments and debt repayments, usually characterized by a fall in its net worth below the value of its liabilities;

(b) Credit, or the potential default or bankruptcy of a borrower or customer with financial obligations to a company;

(c) Liquidity, or the potential inability of a company to pay its short-term obligations, such as the ability to generate cash to pay its working capital needs or repay financial obligations that become due;

(d) Market, or fluctuations in asset prices such as foreign currency exchange rates or commodity prices that can adversely affect the profitability of a company;

(e) Macroeconomic, or potential general economic downturns, inflation and deflation and changes in interest rates that can affect the financial position of a company.

17. Non-financial risks stem from operational and political factors, as well as environmental, social and governance-related issues, as follows (despite the term non-financial, such risks typically have financial implications in that they may restrict, limit or disrupt the operations of a company):

(a) Operational, deriving from reduced operating capacity, such as malfunctioning equipment or processes, problems with logistics and procurement, cyberattacks or terrorism-related incidents;

(b) Political, deriving from changes in government policies and regulation, sanctions or unrest and conflict;

(c) Environmental, deriving from climate change-related events or severe weather conditions and natural disasters such as droughts and floods;

(d) Social, deriving from disruptions to labour supply, such as through issues with employee health and well-being, consumer and employee boycotts and strikes or reputational risks from socially unacceptable business practices;

(e) Governance-related, deriving from leadership and oversight failures or employee activities not in the best interests of capital providers, such as fraudulent activities and malfeasance.

18. Risks are numerous and of different types, and are often interrelated. Not all risks affect all companies equally. Some are specific to a sector and some to a company, while some are systematic risks that affect all companies, although to varying degrees. The time horizon also influences whether risks are material to a specific company; some risks, such as those stemming from climate change, may become material only in the long term. In addition, different users of financial statements are concerned with different types of risks and therefore need different types of information.

[12] FH Knight, 1964 [1921], *Risk, Uncertainty, and Profit* (Sentry Press, New York).

C. Current practices in risk disclosure in corporate reporting

19. Risk disclosure requirements for corporate reporting vary worldwide and can be considerable. Generally, corporate reports are relevant to assessing risks to a business. Material risks are often disclosed throughout various sections of an annual report; some are mandated by reporting standards and some by regulatory bodies and securities laws as a precondition for listings on regulated markets, that is equity or debt markets. Relevant requirements and guidelines under the International Financial Reporting Standards include Standard 7 on financial instruments and the framework for the presentation of management commentary.[13] Summary measures in financial statements, such as for earnings and cash flow, as well as other recognized financial statement amounts, are also useful in assessing company risks. Not all of these requirements necessarily mention the word risk, yet risk disclosure is often determined by the underlying objective that such disclosure should be useful to investors in decision-making.

20. Some examples of important requirements in the United States of America and the European Union are provided in this section. While some risks are presented within narrative reporting and tend to be qualitative, specific risks inherent in certain items are disclosed within financial statements in accordance with requirements under applicable accounting standards.

21. Risk disclosure requirements for companies in the United States are prescribed in securities laws, regulations of the Securities and Exchange Commission and reporting requirements under the national generally accepted accounting principles.[14] On forms 10-K (annual report) and 10-Q (quarterly report) of the Commission, listed companies are required to disclose the most significant risks they face under the item on risk factors and are also required to discuss the risks that materially affect their liquidity, capital and revenues under the item on management discussion and analysis.[15] Disclosure requirements under the latter item are general, in order to provide flexibility to reporting companies, acknowledging that not all companies face the same risks.[16]

22. In the European Union, Directive 2003/51 on annual and consolidated accounts and Directive 2004/109 on transparency requirements include articles that require companies to disclose in their annual and interim reports a "description of the principal risks and uncertainties" the reporting company faces (articles 1.14 and 5.4, respectively). However, the directives do not provide guidance on what constitutes principal risks and uncertainties. In the United Kingdom, companies are required to present a description of risks in a director-level or management report as part of their annual financial reports.[17] The United Kingdom has additional risk reporting requirements with regard to the risk management systems of a company and the risk of investments in financial instruments.[18] Other countries in the European Union have similar requirements. Germany, for example, also requires the disclosure of risks in a management report, and further requires companies

[13] International Accounting Standards Board, 2010, Practice statement: Management commentary, available at https://www.iasplus.com/en/standards/other/management-commentary.

[14] See for example items 302, 303, 305 and 503 of Securities and Exchange Commission, 2017, Code of Federal Regulations, Title 17, part 229, available at https://www.sec.gov/about/laws/secrulesregs.htm.

[15] See https://www.sec.gov/forms. The Commission introduced the risk factor disclosure requirement in 2005 (Securities and Exchange Commission, 2005, Securities offering reform, Release No. 33-8591, available at https://www.sec.gov/rules/final/finalarchive/finalarchive2005.shtml). Before risk disclosures became mandatory, United States accounting standard setters encouraged the disclosure of quantitative information about certain risks (Financial Accounting Standards Board, 1998, Accounting for derivative instruments and hedging activities, Statement No. 133).

[16] Securities and Exchange Commission, 2003, Interpretation: Commission guidance regarding management's discussion and analysis of financial condition and results of operations, available at https://www.sec.gov/rules/interp/33-8350.htm.

[17] Financial Conduct Authority, 2017, Disclosure guidance and transparency rules sourcebook, available at https://www.handbook.fca.org.uk/handbook/DTR/4/1.html; United Kingdom, 2006, Companies Act.

[18] Financial Conduct Authority, 2017; Financial Reporting Council, 2016, United Kingdom corporate governance code. There are several standards related to specific assets and liabilities such as financial instruments that require quantitative or qualitative risk disclosures.

to quantify risks if this is performed for internal management purposes and the risks are material.[19]

23. Directive 2014/95 on the disclosure of non-financial and diversity information requires large companies listed on European Union markets and those in the financial sector to disclose in management reports information on the main human rights-related, environmental, social and anti-corruption risks.[20] Other jurisdictions may have similar requirements, such as in appendix 16 on the disclosure of financial information of the listing rules of the stock exchange of Hong Kong, China, or more extensive reporting requirements, in particular with respect to sustainability and governance information, such as the listing requirements for the Australian Securities Exchange, the B3 stock exchange in Brazil and the Johannesburg Stock Exchange in South Africa.

24. The International Financial Reporting Standards include several further requirements for specific risks that must be disclosed as part of financial instruments. Standard No. 7 has extensive and detailed qualitative and quantitative risk disclosure requirements related in particular to credit, liquidity and market risks arising from a company’s use of financial instruments.[21] Similarly, International Accounting Standard No. 37 on provisions, contingent liabilities and contingent assets requires a discussion of uncertainties related to provisions and contingent liabilities.[22] Such disclosures must be made in financial statement footnotes.

25. Financial institutions face a number of financial and non-financial risks. In addition to the examples of financial reporting requirements given in this section, financial institutions are regulated under the capital adequacy framework of the Basel Committee on Banking Supervision. Pillar 3 of the revised framework requires banks to disclose quantitative and qualitative information on their risk management approaches, various regulatory capital indicators and measures and risks related to markets, credits and counterparties, as well as off-balance sheet exposures.[23] The disclosure requirements are aligned with but also more extensive than financial reporting disclosure requirements for financial instruments.

III. Main issues in risk disclosure and current developments

A. Challenges for preparers and users of risk disclosures

26. Preparers and users of corporate reports face several challenges with regard to risk disclosure, as follows:

(a) Disclosures and requirements often vary in quantity, quality and location, and specific requirements are often ambiguous;

(b) Generic and boiler plate language is often used;

(c) There is often a lack of focus on material risks;

(d) Disclosures are afforded flexibility, in order to be useful, and are often company-specific, which undermines their comparability and reliability;

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[19] Accounting Standards Committee, 2012, *Group Management Report* (Federal Ministry of Justice, Berlin).

[20] Member States of the European Union were required to bring into force the national laws necessary to comply with the directive by December 2016, and the first annual and periodic reports required to include such disclosures are those for 2017.

[21] International Accounting Standards Board, 2005, International Financial Reporting Standards 7: Financial instruments – disclosures.

[22] Similar requirements exist under the United States generally accepted accounting principles; see Financial Accounting Standards Board, 2010, Accounting standards codification, No. 450: Contingencies, available at https://www.iasplus.com/en-us/standards/fasb/liabilities/asc450.

[23] Bank for International Settlements, 2015, Revised pillar 3 disclosure requirements, available at http://www.bis.org/bcbs/publ/d309.htm.

(e) Many risks are difficult to measure (due to choices in measurement, time horizons and granularity) and often cannot be quantified without the use of subjective assumptions;

(f) Users, including sophisticated investors, may construe more detailed disclosures as evidence that a company is facing more risk, which may deter other companies from disclosing risks.

27. One of the main criticisms of risk disclosures is that current requirements are often ambiguous, providing companies ample discretion as to the depth and breadth of disclosures about the material risks they face.[24] Furthermore, risk disclosures are currently dispersed throughout several sections of annual reports and included in both audited and unaudited sections.[25] Such variability in the quantity, quality and location of disclosures provides investors with limited means to assess their accuracy or completeness.

28. Dedicated sections may be prescribed for risk disclosure, such as under the item on risk factors on the annual report form of the Securities and Exchange Commission, yet companies often continue to use generic language that may render them uninformative. For example, regulation S-K of the Commission states that risks that could apply to any company should not be presented, and that disclosures should be more specific and focused. Moreover, the use of boiler plate disclosures throughout financial reports has generally reduced the usefulness of reports by obfuscating material information, which complicates investor efforts to assess risks to investments.

29. In order to avoid subsequent criticism for omissions or misstatements and potential litigation, companies tend to err on the side of comprehensiveness rather than conciseness. When a company applies materiality assessments to risks for which the impact on the firm is inherently difficult to assess, it therefore tends to favour comprehensive but generic disclosures. This makes it difficult for investors to identify the principal and most material risks specific to the company.[26] There is thus a trade-off between comprehensiveness in a report, to cover all potential risks, and the materiality of risks and their relevance to investors.[27] This occurs because preparers face the high costs of underreporting risks, such as reputational and litigation-related costs, while investors face the high costs of extracting relevant information from many reports. In addition, there is a trade-off between regulating the content and form of risk disclosures, to ease comparability and increase their reliability, and allowing managerial flexibility, to tailor disclosures to company-specific risks. Some risks are inherently company-specific, such as operational risks, and some are common to sectors, such as financial risks. Financial risks can be assessed to some degree by comparing disclosures within a sector, while firm-specific risks are more difficult for investors to assess without firm-specific disclosures.[28]

30. The preparation of risk disclosures is complicated by the fact that some risks, such as financial risks, are within the control of management and can be measured and managed using financial instruments, while others are outside of such control. That is, most business risks are uncertain and cannot be measured objectively, implying that most disclosures of such risks are qualitative and not quantitative. If risk disclosures include quantitative measurements, they are often based on subjective assumptions, unless specific risk measurement models are prescribed by the standard setters.[29] Less prescriptive requirements afford management flexibility in making assumptions specific to a situation

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[24] Institute of Chartered Accountants in England and Wales, 2011, *Reporting Business Risks: Meeting Expectations* (London).

[25] Institute of Chartered Accountants in England and Wales, 2010, *Audits of Banks: Lessons from the Crisis* (London).

[26] Association of Chartered Certified Accountants, 2014, Reporting risk, available at http://www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/pol-afb-rr.pdf.

[27] International Accounting Standards Board, 2017, Disclosure initiative: Principles of disclosure, Discussion Paper DP/2017/1.

[28] O-K Hope, D Hu and H Lu, 2016, The benefits of specific risk-factor disclosures, *Review of Accounting Studies*, 21(4):1005–1045.

[29] SG Ryan, 2012, Risk reporting quality: implications of academic research for financial reporting policy, *Accounting and Business Research*, 42(3):295–324.

and firm. Flexibility can enable companies to make more informative disclosures by using firm-specific model assumptions instead of pre-specified parameters, but also provide opportunities for manipulation. A related issue is whether one or more, various measures, or a statistical distribution, of possible outcomes per risk type or risk group should be disclosed. The Securities and Exchange Commission, for example, provides guidance for statistical disclosures by banks.[30] Another issue relates to the time horizon over which risks should be measured and the level of granularity or aggregation of disclosures.

31. In general, when prescribing specific disclosure requirements, standard setters assess the costs and benefits of reporting. With regard to risk disclosure, an additional potential unintended cost is the signalling effect and the problem of self-fulfilling risks. Investors may interpret more disclosures as equal to more risk. That is, the fact that companies disclose certain risks, such as with regard to liquidity, may lead investors and other stakeholders to act upon the disclosure in ways that reinforce the risk, for instance by withdrawing funding and thereby compromising liquidity. This issue is relevant in particular to banks, but also to companies in other sectors.[31]

32. Such disclosure challenges are amplified with regard to risks such as those stemming from a company's environmental, social and governance policies, as well as those related to climate change. Investors increasingly take into account non-financial factors when assessing a company's risks and opportunities, but have expressed concern over the lack of disclosure quality due to the lack of standards and low comparability, as well as the fact that environmental, social and governance information is not material.[32] Disclosures are complicated by the fact that risks stemming from non-financial factors are difficult to quantify and the exact timing and severity of such risks is difficult to estimate. They are often perceived as becoming material only over the medium to long term.

33. Despite concerns with regard to risk disclosure in corporate reporting, academic studies suggest that such disclosure remains useful to investors.[33] Qualitative risk disclosures in separate sections on risk factors, such as in annual reports in the United States, as well as discussions of risk throughout annual reports, seem to accurately reflect the underlying risks faced by companies.[34] Investors seem to price information about risks in corporate reports, suggesting that risk factor disclosures and management discussions about risk throughout corporate reports are informative in assessing risks.[35] However, studies also suggest that investors do not fully respond to the information in such disclosures, potentially due to difficulties in extracting information from complex reports. Moreover, disclosure by a firm about the potential risks it faces affects investor perceptions of the risks, that is the more extensive the disclosure, the riskier the firm, from the perspective of investors.[36]

B. International projects on disclosures and current developments

34. The Accounting Standards Authority of France, Financial Reporting Council of the United Kingdom and European Financial Reporting Advisory Group issued a discussion paper in 2012 on a disclosure framework for financial statement footnotes, highlighting key features required for effective disclosure. The paper identified the growing complexity of reporting requirements as one factor in the deteriorating usefulness of note disclosures and clarified the role of notes as complements to primary financial statements.

[30] See https://www.sec.gov/files/industryguides.pdf.

[31] G Meeks and JG Meeks, 2009, Self-fulfilling prophecies of failure: The endogenous balance sheets of distressed companies, *Abacus*, 45(1):22–43.

[32] See for example Sustainability Accounting Standards Board, 2016, Climate risk: Technical bulletin.

[33] See for example JJ Filzen, 2015, The information content of risk factor disclosures in quarterly reports, *Accounting Horizons*, 29(4):887–916.

[34] F Li, 2006, Do stock market investors understand the risk sentiment of corporate annual reports? Working paper, Shanghai Jiao Tong University. It remains unclear from such studies whether risk disclosure provides a complete reflection of underlying economic risk.

[35] Filzen, 2015.

[36] TD Kravet and V Muslu, 2013, Textual risk disclosures and investors' risk perceptions, *Review of Accounting Studies*,18:1088–1122.

The paper emphasized that notes should provide information on the risks that affect reported numbers in financial statements.

35. In response to the financial crisis in 2008 and the ensuing crisis of confidence in the banking system, the Financial Stability Board facilitated the establishment of the Enhanced Disclosure Task Force, which published seven high-level guiding principles and made several specific recommendations for enhanced risk disclosure by financial institutions. The seven principles stated that disclosures should be clear and understandable, comprehensive and timely, and should present relevant information, reflect a bank's risk management, be consistent over time and be comparable among banks.[37] The principles aimed to build the foundation for more specific recommendations for transparent, high-quality risk disclosure and to provide a framework for future work on disclosure. Although they were developed for financial institutions, the principles and some of the recommendations provide useful guidance for enhanced risk disclosure by all reporting companies. However, the recommendations focused on financial risks in banking, such as credit, liquidity and market risks, which may not be the primary risks for companies in other sectors. Several other reports on risk disclosure by banks published following the financial crisis identified shortcomings and provided guidance on good practices in risk disclosure.[38]

36. In 2013, the International Integrated Reporting Council issued the *International Integrated Reporting Framework*, with a view to, among others, improving the quality of information available to providers of financial capital, to enable a more efficient and productive allocation of capital.

37. The International Accounting Standards Board is undertaking a broad-based initiative to improve company disclosures under the International Financial Reporting Standards.[39] The disclosure initiative project comprises a number of amendments to existing standards, in particular standard No. 1 on the presentation of financial statements and standard No. 7, along with clarifications and guidance on the applications of materiality assessments, as well as a discussion paper on principles of disclosure. In 2015, the Board issued a draft practice statement on materiality that aimed to support companies in deciding on the information to include in financial statements and the level of aggregation. The statement defined the characteristics of materiality and provided guidance on how to assess the materiality of information. It defined materiality as an entity-specific concept dependent on prevailing circumstances, which might change from year to year, and which took into account the characteristics of the audience of the disclosure. The discussion paper on principles of disclosure, published in March 2017, sets out seven principles of effective communications governing the information that should be disclosed in financial reports and how it should be disclosed. The principles state that disclosed information should be entity-specific, simply and directly described and with an emphasis on important matters, linked with other information in the annual report and not duplicated unnecessarily, comparable over time and provided in a format appropriate for the type of information.[40] The outcomes of this initiative will be relevant to company risk disclosure.

38. In 2015, finance ministers and central bank governors of the Group of Twenty requested the Financial Stability Board to review company disclosures of risks related to climate change, with a focus on the financial sector.[41] A task force on climate-related financial disclosure was established. In 2016, the task force published recommendations on voluntary climate-related financial disclosure, including forward-looking disclosure on the financial impacts of risks and opportunities related to the physical impacts of climate

[37] Enhanced Disclosure Task Force, 2012.

[38] See for example Eurofi, 2012, Risk disclosures: Principles and case studies; European Banking Federation, Association for Financial Markets in Europe, European Savings Banks Group and European Association of Public Banks and Funding Agencies, 2008, Industry good practice guidelines on pillar 3 disclosure requirements for securitization; Financial Stability Board, 2008, Senior Supervisors Group's report on leading-practice disclosures for selected exposures; and Financial Stability Board, 2011, Thematic review on risk disclosure practices: Peer review report.

[39] See http://www.ifrs.org/projects/work-plan/principles-of-disclosure/.

[40] International Accounting Standards Board, 2017.

[41] See http://g20.org.tr/wp-content/uploads/2015/04/April-G20-FMCBG-Communique-Final.pdf.

change and to the transition to a lower carbon global economy, as specified in the Paris Agreement under the United Nations Framework Convention on Climate Change.[42] It recommended that such disclosures be made in already existing financial filings and encompass four core elements, namely governance, strategy, risk management and metrics and targets. The recommended disclosures included scenario analyses of the potential impacts of different climate scenarios on the strategies and finances of companies.

39. The Division of Corporate Finance of the Securities and Exchange Commission is currently reviewing disclosure requirements in its regulations S-K and S-X, which provide the requirements for disclosure in financial statements in the United States. The aim of the review, which focuses on financial disclosure in annual and quarterly reports, is to develop recommendations for improving and facilitating timely and material company disclosures. In 2016, the Commission proposed amendments to eliminate requirements in regulation S-K that were redundant or overlapped with provisions in the financial reporting standards of the United States generally accepted accounting principles and the International Financial Reporting Standards.[43]

C. Other issues in risk disclosure

40. The most extensive disclosure requirements are usually only mandatory for large listed companies. In an effort to balance the benefits and costs of disclosures, standard setters and regulators generally exempt small and medium-sized enterprises and companies not listed on the main markets. For example, companies listed on the Open Market in Germany or on AIM, the market of the London Stock Exchange for smaller growing companies, are subject to less extensive disclosure requirements than those listed on the main regulated markets. European Union directives that govern transparency risk reporting requirements apply only to the main regulated markets. Risk disclosure by large private companies is an issue for further consideration.

41. It may be beneficial for small and medium-sized enterprises to voluntarily comply with more stringent transparency requirements, yet smaller companies and microentrepreneurs often lack the resources to gather and prepare the necessary information for disclosure. Moreover, some risks that affect large international companies may be less material for smaller domestic companies, casting doubt on the cost and benefit trade-off of enhanced disclosure.

42. Considerations of confidentiality also play a role in assessing the cost of disclosure. Companies may be more reluctant to enhance transparency about material risks if enhanced disclosure provides competitors with clues about their strategic positioning. In particular, information about business risks and non-financial risks may reveal proprietary information about the intellectual capital, technology or product market and supply chain strategies of a company, which competitors may exploit to their advantage. In general, the more useful the information to decision-making, the higher the indirect cost of disclosure, in particular if information is provided at a level of granularity similar to that used for internal decision-making and risk management. Companies consider such indirect costs in balancing transparency with confidentiality.

IV. Improving usefulness of risk disclosure for investment decisions

43. There is a general view that risk disclosures improved after the financial crisis as a result of investor pressures, new regulations and stricter enforcement.[44] However, disclosures still do not appear to be well integrated within and across risk types throughout corporate reports, and discretion in presentation yields inconsistencies both

[42] Task Force on Climate-Related Financial Disclosures, 2016.

[43] Securities and Exchange Commission, 2016, Report on modernization and simplification of regulation S-K, available at https://www.sec.gov/files/sec-fast-act-report-2016.pdf; Securities and Exchange Commission, 2016, Business and financial disclosure required by regulation S-K, in United States, 2016, *Federal Register*, 81(78):23916–24008, available at https://www.federalregister.gov/d/2016-09056.

[44] Association of Chartered Certified Accountants, 2014.

within and across companies. Generally, disclosures should aim to provide complementary, often forward-looking, information to, mostly historical, financial statement numbers. The goal should be for investors to understand from a disclosure which risks are material to a company, the magnitude of the company's exposure to the risks and how the company manages the risks. In order to achieve this goal, it may be less effective to require the expansion of current disclosures and more important to enhance the following:

(a) Focus on most material risks;

(b) Structure and readability;

(c) Comparability across companies and over time.

44. This chapter suggests potential ways to improve disclosure and provides suggestions for discussions of each aspect in greater detail.

45. Recent efforts by the International Accounting Standards Board to clarify the definition of materiality and its assessment should aid companies in focusing their reporting in financial statements on the most important risks they face and reducing the amount of generic language used when describing risks in management reports or separate risk reports. A distinction between primary and emerging risks as reported by some companies may help investors understand how management views and manages risks. Primary risks may be defined as risks that have or might become material in the short term, such as in one year, while emerging risks may be defined as risks that might become material in the long term. A clear distinction of the most material risks also allows companies to reference risks throughout a financial report, to enable investors to understand the financial implications. A summary index that cross-references the risks under discussion with the rest of the financial report and links to financial statements may also help guide investors.[45]

46. Another consideration relates to how a company's exposure to material risks should be disclosed, namely the consideration of which information about each risk is useful for assessing the risk in question, how management is mitigating that risk and how that risk is changing over time. Related issues involve deciding whether disclosures should be quantitative or qualitative or vary by type of risk, and whether they should include a company's explicit assessment of the risk or provide investors with enough information to make their own assessments, as well as the level of aggregation and the method of presentation that should be used, that is narrative or tabular form or aggregate measures. For example, the approach of standard setters in Germany, which requires the disclosure of quantitative risk measures if used for internal decision-making purposes, may be an example of a good practice, as the measures are already collected internally and the additional compliance burden on companies is therefore likely to be low, and such information may provide investors with additional insight as to how a firm manages its risks. Measurements may include those that use historical data or predictions about possible future outcomes. Summary measures and disaggregated risks are likely to be the most useful, and might include measures such as value at risk or expected losses if the risk becomes material, which provide investors with a single figure of the potential financial impact and may be further disaggregated by type of risk, business segment or geography.[46] In this regard, a tabular form, along with narratives, is likely to lower extraction costs for investors. Quantitative disclosures should include assumptions about the historical and forward-looking characteristics of model inputs, as well as sensitivity analyses of model outputs with regard to changes in the assumptions.

[45] For similar recommendations, see SG Ryan, 1997, A survey of research relating accounting numbers to systematic equity risk: Implications for risk disclosure policy and future research, *Accounting Horizons*, 11(2):82–95.

[46] See S Rajgopal, 1999, Early evidence on the informativeness of the SEC [Securities and Exchange Commission]'s market risk disclosures: The case of commodity price risk exposure of oil and gas producers, *The Accounting Review*, 74(3):251–280; and DB Thornton and M Welker, 2004, The effect of oil and gas producers' financial reporting release No. 48 disclosures on investors' risk assessments, *Journal of Accounting, Auditing and Finance*, 19(1):85–114.

47. If the risk measures disclosed are also used for internal risk management purposes, it may be useful for investors to understand how different risk measures relate to internal incentive mechanisms, that is, how management remunerations are affected by variations in the risk measure. Information about ex post realizations of risk further enable investors to assess how well companies have estimated risk exposures and managed risk. The extensive and revised risk and risk management disclosure by regulated companies, such as banks and insurance companies, following the financial crisis may provide relevant examples of good practices.[47] Other examples may come from risk disclosure in security prospectuses required before a public offering, which are typically more extensive and better structured than those in annual reports.

48. Generally, investors and regulators are more sensitive to specific risks after they have become material during a crisis. In response, companies are often mandated to or voluntarily improve risk disclosure in particular areas. For example, the operational risk disclosures of extractive industries improve after significant oil spills in water bodies, and the credit and liquidity risk disclosures of banks were developed following the financial crisis.[48] Further consideration of the improvements made may provide insights of avenues for the improved disclosure of other types of risk. Furthermore, the greater integration of risks disclosed in financial statements and sustainability reports is important.[49]

49. Finally, another consideration relates to whether the behavioural biases of investors should be taken into account in devising appropriate risk disclosure mechanisms. Research in psychology and behavioural economics suggests that investors pay limited attention to complex disclosures and, in particular, undervalue statistical information in decision-making. The presentation and salience of information influences how investors interpret information.[50] Such considerations are particularly important when risk disclosure is also aimed at assisting less sophisticated investors in making investment-related decisions.

V. Conclusion and way forward

50. This note reviews issues related to the role of disclosure in risk assessment and their usefulness in decision-making. Information disclosure by companies is pivotal for the functioning of capital markets in facilitating the allocation of capital to productive investment opportunities. Although extensive mandatory disclosure requirements exist and companies also voluntarily disclose a variety of financial and non-financial information to satisfy the information needs of investors, corporate reports have increasingly been criticized as being too complex, cluttered and generic, thereby compromising their usefulness. In particular, corporate disclosure has increasingly been driven by compliance considerations, rather than explored as an effective means of communication.

51. The financial crisis highlighted the lack of control systems over risks and the absence of effective reporting by companies. This note identifies the following issues that complicate investor efforts: risk disclosures are dispersed throughout financial reports, often without links to potential financial impacts; disclosures use generic language and lack focus and comparability; and the disclosure efforts of companies are constrained by measurement and materiality issues, indirect costs and trade-offs between transparency and confidentiality. In response, several international standard setters have proposed projects on high-level guiding principles for good practices in risk disclosure, in order to enhance the usefulness of corporate reporting. Based on insights from this work, current practice and academic studies, this note highlights issues for discussion and provides initial suggestions for enhancing the usefulness of risk disclosure.

[47] Additional examples of good practices are available in Enhanced Disclosure Task Force, 2012.

[48] See additional examples in Association of Chartered Certified Accountants, 2014.

[49] World Business Council for Sustainable Development, 2017, *Sustainability and Enterprise Risk Management: The First Step towards Integration* (Geneva).

[50] L Koonce, ML McAnally and M Mercer, 2005, How do investors judge the risk of financial items? *The Accounting Review*, 80(1): 221–241; MW Nelson and KK Rupar, 2015, Numerical formats within risk disclosures and the moderating effect of investors’ concerns about management discretion, *The Accounting Review*, 90(3):1149–1168.

52. In this regard, delegates at the thirty-fourth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting may wish to consider the following issues for deliberation:

(a) What are the main challenges in establishing harmonized standards for risk disclosure, in particular among listed or multinational companies? What needs to be done to better align risk disclosure in financial statements and narrative reporting in other parts of corporate reports? Are there good practices to be shared?

(b) What is the optimal level of disclosure that can balance the information needs of users with the capabilities of preparers, and address issues of transparency and confidentiality?

(c) Is consistency required between disclosures of financial and non-financial information? What are the main challenges?

(d) Should risk disclosure requirements and guidelines take into consideration the specific challenges of large private companies, small and medium-sized enterprises and the public sector, as well as companies operating in developing countries and countries with economies in transition?

(e) How can global forums such as the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting further contribute to consensus-building on the topic of risk disclosure?