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《論　　説》

The UK Guidelines for Company Risk Reporting−An Evaluation

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1. Introduction

Although risk reporting is a burning issue in the corporate world, it was not even being talked about until the last few years. But, for better corporate governance, along with other vital disclosures, risk disclosure is also very important both for the stakeholders and the company. As an interested party to the company, investors will always be eagerly waiting to know the risk status of the company. They always want to see the company's risk position through the eyes of the management and want to be assured about their stake intact in the company. Everywhere in the world, companies need to report as per their statutory regulations. But, is a statutory regulation enough to make a company disclose all relevant information to satisfy stakeholders? To comply with the regulations for better corporate governance disclosure, companies have been reporting about risk information for a long time. But, that sort of disclosure raised a number of questions : , Does this disclosed risk information fulfill the requirements of the users of annual reports? What are the ways companies are reporting the risk, or how these risks are being identified and measured? Are there any formal guidelines for reporting risk? To what extent this risk information should be disclosed is also an issue of debate. Consequently, different professional and regulatory bodies in different countries become concerned about this issue and issued pronouncements to give clear guidelines. The Institute of Chartered Accountants of England and Wales (ICAEW), The Canadian Institute of Chartered Accountants (CICA), and The German Accounting Standard Board (GASB) are just three examples of concerned organizations.

Few studies have been carried out by academic researchers on this issue. Most of the research studies have been undertaken by the professional regulatory bodies in different countries. In particular, ICAEW has issued several pronouncements and a benchmarking study regarding risk reporting. It has issued the Financial Reporting of Risk : Proposal for a statement of business risk in 1997. After that proposal, risk reporting has become a better known issue in the corporate world and consequently other professional bodies and concerned authorities have become more interested in it. This historic step convinced the researchers to conduct a study to

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evaluate the guidelines and pronouncements issued by ICAEW regarding company risk reporting. This study will attempt to find out the ins and outs of the risk reporting guidelines. The study also aims to find out any loopholes of the guidelines and tends to give suggestions to overcome/improve the problems. For this study, guidelines, proposals and concerned accounting standards issued in UK, Canada & Germany have been consulted thoroughly. And relevant literatures have also been studied.

2. Analysis of the guidelines in the UK

2. 1 Risk disclosure guidelines/pronouncements in the U. K.

The risk disclosure debate and the Institute of Chartered Accountants in England and Wales (ICAEW) are inseparable. ICAEW has taken a pioneering role in promoting the idea that companies–and particularly listed companies–should report on their major business risks and how management deals with them. It has issued several pronouncements regarding risk reporting (table 1) which advocate that this issue should be seen as a vital need in the corporate world. Some of the pronouncements are directly related to the risk disclosure issue and some are related indirectly.

In fact, the risk disclosure debate was brought into the spotlight by ICAEW through a discussion paper "Financial Reporting of Risk–Proposals for a Statement of Business Risk" in 1997. Although, ICAEW has published several subsequent papers on this issue this paper had exceptional importance as it brought the risk reporting idea in to the light for the first time. According to this proposal, companies with publicly traded shares should lead the introduction of enhanced risk reporting in annual reports. Enhanced information about what companies do to assess and manage key business risks of all types will : provide practical forward–looking information ; reduce the cost of capital ; encourage better risk management ; help to ensure the equal treatment of all investors ; improve accountability for stewardship, investor protection and the usefulness of financial reporting. However, the institute took consideration valuable constructive comments from various professional bodies and academics regarding this issue and, issued several further pronouncements in 1999 and 2002.

Table 1 : List of pronouncements issued by the ICAEW concerning the risk affairs :

Pronouncement	Date
Business Risk Management	1996
Financial Reporting of Risk : Proposal for a statement of business risk	1997
No Surprises : The case for better risk reporting	1999
The Turnbull Report on internal control : Guidance for directors on the combined code	1999
Inside Out : Reporting on shareholder value	2000
No Surprises : Working for better risk reporting	2002
Risk Management for SMEs	2002

[Source: Shrives, P. J. and Linsley, P. M. (2003). *Risk Reporting by UK and German Companies : Towards Meaningful Disclosure?*]

2. 2 Concept of risk

There has been a debate about the definition of risk from the inception of the risk reporting issue. For example, whether it will encompass the term 'uncertainty' or not, whether risk would be inclusive or not, and whether it will be a downside risk only or not. But, it is beyond any debate that risk is inherent in business. Although the nature and extent may differ, risk is applicable to all types of business. A company takes risk in order to pursue opportunities to earn returns for its owners ; striking a balance between risk and return is the key to maximizing shareholder wealth (ICAEW, 1997). ICAEW (1999a) mentions in the Turnbull report that risk is not only 'bad things happening', but also 'good things not happening'.

However, ICAEW took the definition of risk from *FRS 5 : Reporting the substance of transaction* : "uncertainty as to the amount of benefits. The term includes both potential for gain and exposure to loss". Business risk is thus the amount of uncertainty as to the benefits that the business will derive from pursuing its objectives and strategies. ICAEW (1999b) shows that risk is a big pervasive business issue and encourages an inclusive approach to risk that should not concentrate on a few sources of uncertainty, such as so–called financial risk. It also shows that since risk is associated with uncertainty, and because of uncertainty actual cash flows will turnout differently from period to period. That is why risk should be seen as representing volatility. It is also true that risk is not just downside only. Depending on the cash break–even line it can be both upside and downside. An extreme case where only upside risk will results that have any likelihood of happening give a positive net cash flow. On the contrary, an extreme case where there is only downside risk, every result that has any likelihood of happening has a negative net cash flow. Managing downside risk is an important part of risk management. But, it is not the whole of the story. Risk managers should not adopt a lop–sided approach. Rather, they should be actively managing all uncertainty and taking cost–effective action to increase the likelihood of better results and decrease the likelihood of worse results (ICAEW, 1999). This idea is also well supported by KPMG[3] (1998).

"*If companies report only one side of the equation* (*the risk*) *without reflecting the opportunity* (*or the mitigating*) *there will be yet more pressure for organizations to become risk averse, stifling entrepreneurialism*."

2. 3 Classification and Identification of risk :

For analysis and comparison risk needs to be properly classified but there is no hard and fast rule. ICAEW uses the Arthur Andersen Business Risk Model™. According to this model risk is divided into three major categories are environment risk, process risk and information for decision making risk. Furthermore, all the three major categories of risk are divided into many types. These classifications of risk are vital in the drive to achieve comparability in risk reporting.

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[3] An audit firm passed its comment on risk and was cited in ICAEW, (1999b).

ARTHUR ANDERSEN *BUSINESS RISK MODEL™*

Diagram 1 : Risk classification and identification model

[Source: ICAEW, The Institute of Chartered Accountants in England and Wales (1997). *Financial Reporting of Risk : Proposals for a Statement of Business Risk*, ICAEW, UK.]

ICAEW president Wyman[4] (2002) also highlighted the importance of classifying risk in achieving comparable and consistent reporting. But, it does not necessarily mean that companies should report against every risk on a standard check list. Rather, the aim is to use a common menu to report on the risks that are most relevant to them.

As part of risk management and risk reporting, it is very important to identify the risk in a company. Although it is very important to identify the risk this is not a very easy job (Hookana, 2003). However, as an investor provides capital to a whole enterprise, all types of risks are relevant to him. Any information may be useful to investors to assess future prospects. But some existing requirements and guidelines only partially fulfil risk disclosure. For example, SSAP 25[5] deals with segment concentration and FRED 13 deals with disclosure of derivatives and other financial instruments (cited in ICAEW, 1997).

The risks identified in the Arthur Andersen model can be classified into internal and external risks.

[4] ICAEW president' speech on ICAEW, (2002).

[5] SSAP 25 requires major companies to disclose information about the different classes of business and the different geographical areas in which they operate. Accounting Standard Board (1990), UK

'Environment risk' is considered as an external risk as it results from circumstances outside the enterprise which are difficult or impossible to control. On the other hand, 'process risks' and 'information for decision–making risk' are considered as internal risks as they are the results of business activities which are more controllable than external risks. According to the business risk model, financial risk has been identified as a component of internal risk and it may be summarized as the risk that cash flows and financial risks are not managed cost effectively to maximize cash availability ; to reduce uncertainty of currency, interest rate, credit and other financial risks ; and to move cash funds quickly and without loss of value to wherever they are needed most. As financial risk can have a direct effect on monetary assets and liabilities, it deserves to be reported in a proper way. On the other hand, non–financial risk can be defined as those risks that do not relate directly to monetary assets and liabilities. But, they have indirect financial implications for cash flows and profitability in the long run. That is why ICAEW (1997) termed it as 'Indirect financial risk'.

2. 4 Prioritizing key risk

The need for information varies from user to user and the importance of risk also varies from company to company. For that reason, a wide range of risks that a company can face should be listed and prioritized. ICAEW (1997) mentions relevant risks include product or service failure, which may result in loss of sales, cash flow difficulties and reduced stock values ; actions taken by regulators, which may threaten an enterprise's ability to carry on or develop its business in accordance with established strategies ; product development, where there may be high–up front costs of research and development but the potential for significant increases in sales in the future.

Reporting all risks does not necessarily mean that irrelevant risks need be reported. The ICAEW suggests (1997) risks should be prioritized so that only significant and material risks can be reported. Depending on the nature of the organization and attitude of the management to risk, the priorities of risks may be different. However, for prioritization, the institute recommends a risk mapping or profiling method. Risk mapping considers the significance of a risk to the business as well as the likelihood of its occurrence. By this mapping it is possible to prioritize the risk. See diagram 2 which shows such features as where product development, and trademark/brand name erosion have a high likelihood of occurrence as well as a high level of significance. These risks should be prioritized. On the other hand, other factors such as Health & safety, price–commodity, and the environment have a low level of significance and less likelihood of occurrence and so should be excluded from the priority list.

2. 5 Describing actions taken to manage each risk

Financial Reporting of Risk (ICAEW, 1997) mentions that merely identifying risk and reporting to stakeholders is not meaningful enough. Investors also want to know the details of risks and the capability of management to handle those risks. Companies in the same industry may have the same level of risk but may not

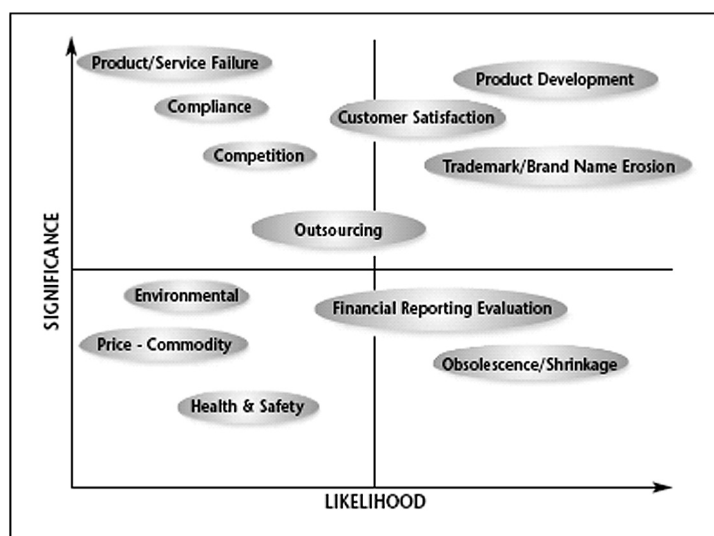

Diagram 2 : Risk mapping

[Source: ICAEW, The Institute of Chartered Accountants in England and Wales (1997). Financial Reporting of Risk : Proposals for a Statement of Business Risk, ICAEW, London.]

have the same level of managerial efficiency to handle risk. The strategies, objectives and level of tolerance vary from firm to firm. Risk statements should therefore, describe key business risks and how each one will be managed. The risks facing a business enterprise can be reported in a 'gross' or 'net' form. Gross risks are the risks facing an enterprise before any action is taken to manage them. Whereas risks still remaining with the business after taking measures are called net risks. Management normally take formal and/or informal measures to manage risk and to lessen their exposure so that it will enhance the upside opportunity and reduce the downside risk. So, naturally investors will be interested to know the actions taken to manage risk.

Another important topic is form of risk disclosure is beneficial to users. One group is in favor of net risk disclosure arguing that 'net risk' is concerned with the investors' decision. On the other hand, another group favors eporting 'gross risk' disclosure. Because they want to see the gross risk volume and management actions to manage that risk, which are more meaningful presentation for investors. However, ICAEW (1997) mentions that net business risks alone are likely to be misleading and a disclosure of actions taken to manage gross risk is essential. Therefore, it is more acceptable to report the gross risk and action taken to manage that to make it net.

2. 6 Measurement of risk

Companies use different varieties of risk measurement system according to the attitude of the management. But, whatever the risk measurement system applied that should be reported in external reporting. Firms are always trying to develop better measurement systems which will be regarded for their credibility and comparability. According to ICAEW (1997) risk measures include accounting measures, non–accounting

measures, sensitivity analysis and value at risk (see diagram 3). Accounting measures consist of contingencies, expected values, discounting, ratio analysis, rating process, and other accounting information such as measures of concentration, trend analysis and benchmarking. However, accounting measures have some limitations. Accounting figures relating to risk may be reported but without supplementary disclosure risk is not really conveyed to the users clearly. Accounting measures are sometime inadequate or incomplete. For example, if a key risk relates to the recruiting and retaining of scarce qualified staff, it is hard to think of really pertinent accounting measures which will include such factors (ICAEW, 1997). In those cases firms may use some non–accounting measures from within the business or from external sources to report risk information. However, there is no best fit measure which can be identified as standard for a firm. Different firms use different measures even in the same industry. ICAEW (1997) says that “Firms that are better at measuring risk will be better at allocating capital internally and deciding on the most cost–effective way to manage a risk, for example by transfer or control”. So, it is to be expected that new measures will be developed by firms who really want to be rewarded in this regard. Firms having better risk measures will gain a competitive advantage over other firms.

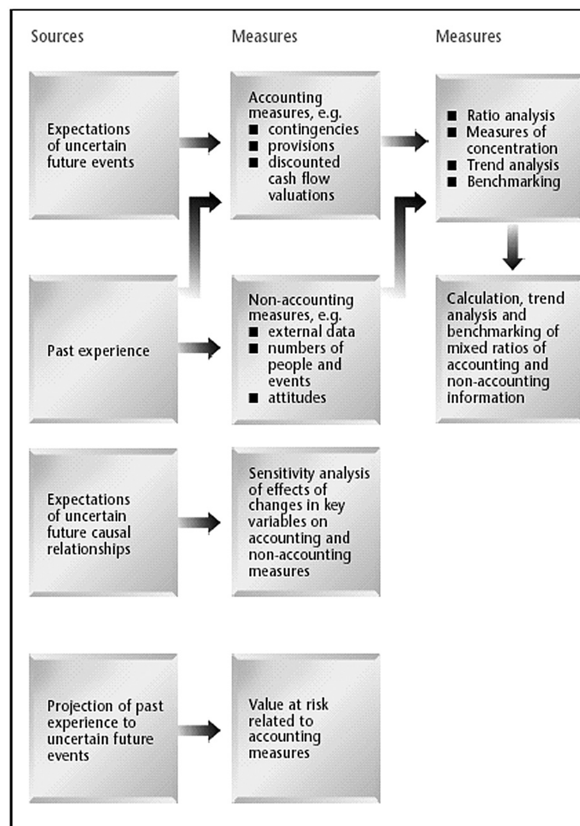

Diagram 3 : Measures of risk

[Source: ICAEW, The Institute of Chartered Accountants in England and Wales (1997). Financial Reporting of Risk : Proposals for a Statement of Business Risk, ICAEW, London.]

2. 7 Disclosure of the risk statement

Finally, before publishing statements of risk information, directors should check thoroughly that they are accurate. ICAEW (1997) states in the Financial Reporting of Risk that "because of the challenges involved in prioritizing risk and developing appropriate risk measures and supporting information systems, directors might wish initially to prepare and refine a statement of business risk for internal use before proceeding to publication". The institute mentions this statement of risk as a voluntary statement. Although, there are some partial mandatory requirements for financial risk disclosure (FRED 13 Derivatives and other financial instruments, 1998), directors go beyond these minimum requirements. However, the proposal emphasises that before publishing the statement directors need to : make appropriate cross–references to other risk–related disclosures to avoid unnecessary duplication ; ensure that the statement only deals with material issues, appropriate for the intended audience and omits information on grounds of commercial sensitivity where this is in the overall interests of the company ; satisfy themselves that the prioritization of risks and the development of appropriate risk measures and supporting information systems have been adequately considered within the business ; and confirm that no legal exposures arise from the statement (ICAEW, 1997).

2. 8 Significance of three consecutive pronouncements on risk reporting

Considering the proposal in the Financial Reporting of Risk (1997), UK directors show a lack of confidence in the relationship between risk disclosure and the cost of capital on the grounds of commercially sensitive risk information and with the disclosure of forward–looking risk information (Linsley et. el. 2003). Directors opposed saying that the benefits did not outweigh the potential costs of disclosure. These potential costs consist of the proprietary costs of information retrieval and non–proprietary costs of disclosing information that is commercially sensitive and therefore of value to competitors. This non–proprietary cost relating to competitive disadvantage was of the most concern to the respondents to the proposal. In 1999, the ICAEW's discussion paper "No Surprises–The Case for Better Risk Reporting", came with the suggestion that commercially sensitive risk information could be omitted from the disclosure. It also suggests directors present disclosures of key risks, the related actions they plan to take to address them, and any other relevant measures. Even so, criticisms of this suggestion were still made. Companies have the scope to escape from disclosing some important risk information marked as commercially sensitive, which an ultimately lead to disclose unspecified risk information, and actions taken to manage the risk. Taking into consideration the responses to the earlier paper (ICAEW 1999b), a survey of the views of FTSE 500 companies to the proposals, and a benchmarking study by some companies on risk disclosure, ICAEW issued "No Surprises : Working for better risk reporting" in 2002. The institute sees very important benefits for companies in providing better information about what they do to assess and manage key business risks. Such information will : provide practical forward looking information ; reduce the cost of capital ; encourage better risk management ; improve accountability of stewardship, investor protection and the usefulness of financial reporting. The institute is particularly convinced

that enhanced risk reporting will help listed companies obtain capital at the lowest possible cost. Therefore, ICAEW (2002) recommended that listed company annual reports should contain information about risk in the broadest sense, about actions to manage them and relevant measures. Such information need not necessarily be included in a separate report.

3. Concerned research findings on risk reporting issue in UK

Linsley and Shrives (2002, 2003) have conducted three complementary studies on risk reporting. Their first study (2002) examine the risk disclosure practices as stated in the annual reports of UK FT–SE 100 non–financial companies. The second (2003) compares risk disclosures in 22 German and UK companies as a matched pair approach from within the Global Fortune 500. The third study (Linsley, Shrives and Crumpton, 2003) examine risk disclosures within the annual reports of Canadian and UK banks. All three studies have been carried out using similar research method tested several hypotheses about risk reporting. The results show that there is a positive relationship between the volume of risk disclosures and company size ; that is, Larger organizations are disclosing more risk information than small scale ones. organizations. But, these studies do not cover the quality of the disclosed risk information. As it deals with total disclosed information not only with any specific risk information, we can not be assured that large organizations are disclosing very useful and material risk information which help them to retain their size and trust within the industry. It is also been found that the number of neutral disclosures[6] is significantly greater than both the number of good and bad disclosures. This also signals that large sized organizations do not necessarily disclose useful risk information. The studies also confirm that financial companies disclose greater amounts of risk information than non–financial companies. This finding also can be interpreted as a result of the peculiarity of the sample organizations. Financial companies have special characters which compels them to disclose extra risk information. The number of non–monetary disclosures was found to be significantly higher than the number of monetary disclosures. This also confirms that directors may be reluctant to quantify risk although this would improve the quality of risk reporting. The difference in the number of past and future risk disclosures was not found to be statistically significant, and no association was found to exist between the level of company risk and the number of risk disclosures in the UK study.

4. Existing Risk Reporting Requirements

4. 1 Operating and Financial Review (1993)

The Operating and Financial Review (OFR) was introduced by the Accounting Standard Board (ASB) for

[6] Neutral disclosures primarily comprise risk management policy statements and these are less useful disclosures than discussions of specific risk.

listed companies in July 1993 for disclosing information on risk outside financial statements. It recommends that listed companies should present an operating review, including 'a discussion identifying the principal risks and uncertainties in the main lines of business, together with a commentary on the approach to managing these risks and, in qualitative terms, the nature of the potential impact on results'. The OFR should also include discussion of 'trends and factors underlying the business that have affected the results but are not expected to continue in the future ; and known events, trends and uncertainties that are expected to have an impact on the business in the future' (ICAEW, 1997, 2002). Research findings from a study done by Arthur Andersen (1996) show that only 13 percent of the firms who are providing a formal OFR, or an operating review and a financial review, provide a clear identification and discussions of trends affecting the future ; and, only 18 percent identified the principal risks and uncertainties in their main lines of business. The board updated its statement in 2003. This new OFR guideline also emphasizes like its predecessor, that it intends to persuade publicly traded companies to adopt best reporting practices. The new statement is based around a basic set of principles, backed by recommendations about the types of information that should be disclosed. Although it is not mandatory, ASB chairman Mary Keegan emphasizes its use saying "companies should be following the new guidelines to ensure they are meeting market demands for clear, narrative explanations of their performance".

4. 2 The Turnbull Report on internal control : Guidance for directors on the combined code (1999)

In the field of risk reporting the Turnbull report is also a milestone. The Turnbull guidance is about the adoption of a risk based approach to establishing a system of internal control and reviewing its effectiveness.

It states that good risk management has the potential to re–orient the whole organization around performance. Risk management and internal control are firmly linked with the ability of the company to fulfill clear business objectives. It is important that managers get out of an 'only downside risk' mentally. Risk is not only 'bad things happening', but also 'good things not happening'. Companies are now seeing opportunities from focusing on risk and control, rather than purely focusing on controls.

A risk–based approach can make a company more flexible and responsive to market fluctuations making it better able to satisfy its customers' ever changing needs in a continually evolving business environment. A boardroom briefing of ICAEW suggests treating Turnbull as the opportunity to improve, not only the management of risk, but also the business as a whole. Turnbull suggests a risk matrix by categorizing risk into four groups : business ; financial ; compliance ; and operational and others. In the financial and some other sectors, it will be difficult to categorize between business, financial, operational and compliance risk. Turnbull highlights that the quantification of risk always maynot bring positive results. Of course a detailed quantification of risk can be useful but in a smaller listed company it is perhaps enough to quantify risk as high, moderate or low. It also cites a case study showing that precise quantification of risk can be avoided if it is felt as a source of complicacy and slow downing the process.

4. 3 Other existing risk disclosure requirements in the U. K.

There were a number of other methods of risk disciosure prior to the introduction of Financial Risk Reporting in 1997. These can be enumerated as follows :

(a) **SSAP 25** Segmental reporting : This requires major companies to disclose information about the different classes of business and the different geographical areas in which they operate. Segment information is designed to aid users in understanding accounts more thoroughly and gain an appreciation of the potential for certain forms of risk (political, industry, market) impacting on significant components of the business (ICAEW, 1997).

(b) **SSAP 18** : Accounting for contingencies alerts users to circumstances where an enterprise could incur losses in a future period as a consequence of risks resulting from past business decisions.

(c) **FRS 4** : Capital instrument has lead to a more useful measurement of risks by requiring debt/equity ratios to be comparable and consistent between enterprises.

(d) **FRS 5** : Reporting the substance of transactions has the effect of bringing on to the balance sheet certain assets and liabilities that might have been treated as off–balance sheet. This provides a better indication of the risk state of an enterprise.

(e) **FRS 8** : Related party disclosures require disclosure of transactions involving related parties, which may not be on arms–length terms.

(f) **FRS 13** Derivatives and other financial instruments : Financial Reporting Standard (FRS) 13 is a standard that deals with the disclosure of financial instruments. A key objective of the FRS is that users should be able to receive relevant and reliable information about the extent to which financial instruments contribute to business risk. Appendix 1 to the FRS identifies four components of risk arising from financial instruments. These are as follows : Credit risk ; liquid risk ; cash flow risk ; and, market price risk.

5. Problems and debatable issues

(1) Risk reporting and cost of capital

ICAEW (1997) highlights the relationship between levels of risk disclosure and the cost of capital. It mentions that one of the principal factors affecting the cost of capital is the perceived risk attaching to the firm and its future cash flows. If other things remain the same, firms with more risk have to pay higher rates of interest to borrow funds and have a lower price/earning ratio for their shares. Selva. (1995) confirms this argument mentioning that inadequate information for assessing risk leads to a premium charge by the provider of capital to cover uncertainty beyond normal industry levels. This cost is lower when firms release informative risk disclosures. Thus, better information about risks should lead to a more efficient allocation of capital within the market. Baiman and Verrecchia (1996) confirm the positive relationship between the extent of financial

disclosures, market liquidity and cost of capital (see also Gibbins et al. 1992, and Sengupta, 1998). Botosan (1997) also examines this relationship and attempts to quantify the association. Lang and Lundholm (1996) also confirms these findings. There is a similar study in UK undertaken ICAS (1997) says that the companies are using private communications to enhance investor confidence and their capital raising ability. All the studies were focusing on the relationship between financial disclosure and cost of capital. Even Botosan (1997) states that "for firms with a high analyst following no evidence of an association between measure of disclosure level and cost of equity, perhaps because the disclosure measure is limited to the annual report and accordingly may not provide a powerful proxy for the overall disclosure level when analysts play a significant role in the communication process". Therefore, risk disclosure within annual reports does not necessarily enhance investor confidence and the ability to raise capital at lower cost. ICAEW (1997) risk reporting proposal also mentions that, "It is difficult for research to pinpoint the precise impact of risk disclosure on the cost of capital".

(2) Commercial sensitivity

According to the 'Financial Reporting of Risk' (ICAEW 1997) if any information is commercially sensitive to an unacceptable level, then that information need not be reported. If this sort of information were disclosed to the public, the impact on the business might be seriously detrimental. The London Stock Exchange's listing rules permits a company to exclude certain sensitive information. However, it is difficult to define 'commercial sensitivity', 'public interest', and 'seriously detrimental'. These terms do not contain very clear explanations and so directors can be deliberately vague. If directors find that the disclosure of risk information does not bring any advantage to their company they can avoid disclosing so called commereially sensitive risk information.

(3) Risk reporting and better risk management

Financial Reporting of Risk proposals (1997) states that reporting risk information encourages better risk management. Their slogan is "what gets reported gets managed". Companies who rigorously and consistently risks report are likely having an improved risk management process. This will enhance their cash flows, reduce volatility and reinforce the positive effects on shareholder value that arise from lower interest costs and higher price/earnings ratios. A robust and visible risk management strategy will improve perceptions of management quality and hence strengthen a company.

We can observe that there are different types of risk disclosure practices in companies. There can be good, bad, and neutral disclosures. Research shows that the number of neutral disclosures is greater than both the number of good and bad disclosures (Linsley and Shrives, 2004). Management can disclose risk information in a neutral shape without specific disclosure which will not necessarily mean better risk management.

(4) Quantification and measurement of risk

The quantification of risk is also an issue that should be addressed in the risk reporting discussion. Linsley

and Shrives (2004) say that directors are reluctant to quantify risk although this would improve the quality of risk reporting. Their research findings show that the number of non–monetary disclosures are significantly higher than the number of monetary disclosures. But, the question is how far it is possible to quantify risk. GAS 5 advises that companies quantify risk where it can be done with reliable and recognized methods, and where it is economically justifiable. It is true that, sometimes, risk quantification is not possible, either because of the non–quantifiable nature of the risk, or it is not economically justifiable. Moreover, one concern is about directors' intentions. If they find that risk quantification will lead to an adverse effect on managerial capabilities, they certainly can avoid the quantification showing the excuse of paucity of reliable and recognizable methods.

On the other hand, risk measurement itself is also a problems because, the available risk measures are still not being regarded as standard or sound measurement systems.

(5) Quantity vs. Quality of risk

From the above discussion it can be assumed that some sort of guidelines or accounting standards are necessary for better risk reporting. But, increasing the quality risk disclosures does not ensure a better quality risk disclosure. To ensure quality, ICAEW advise companies to disclose material risks and prioritize them. But, practice might be different. A study conducted by Woods and Reber (2003) shows that GAS 5 has increased the quantity of risk disclosure but it does not necessarily improve the quality of the risk reporting.

(6) Expected common knowledge of investors vs. disclosure

According to the ASB, UK's draft statement of principles, users can be assumed to "have a reasonable knowledge of business and economic activities and accounting". It is normally assumed, depending on the nature or location of the business, a certain level of risk is inherent within a business and concerned users are aware of that risk. It does not mean that companies need not disclose such kind of risk information. In fact, companies should disclose relevant information in a very simple way without making it over lengthy. If there are untypical risks, they should be explained in detail.

However, one concern is about assumed levels of knowledge. Management, if necessary, are able to avoid disclosing some material risk information on the grounds of assumed common knowledge as there are no clear demarcation lines for such knowledge.

(7) Risk reporting to provide forward looking information

ICAEW proposals (1997) state that, financial reporting should provide a wide range of users with information that is useful for making economic decisions. Information that has predictive value is more welcome to users and The information about the future is more relevant to future economic decisions. But, annual reports normally fulfil a stewardship role whereby they publish auditable, historical information (Linsley and Shrives, 2002). In addition to that directors are reluctant to take responsibility for non–auditable future information and legal complications may arise if investors take decisions based on such information. On the other hand,

information about the future is very uncertain and subjective. Moreover, it is critical to identify whether past or future information has a predictive value or not.

(8) Voluntary vs. mandatory risk reporting. Is institutional regulation a help or hindrance?

Voluntary or mandatory risk reporting has been an issue of debate since the inception of risk reporting. Some regulatory bodies (e. g. ICAEW, CICA) are in favor of voluntary risk reporting. Particularly, emphasing the relationship between the cost of capital and the level of risk disclosures. As it is argued that companies can get the cheapest possible capital from the market, they will disclose as much risk information as possible. On the contrary, some regulatory bodies (e.g. GASB) are in favor of mandatory risk reporting. They assume that if there are mandatory guidelines then it is easy to follow and tough to escape from material risk reporting.

Regulation might have both good and bad effects. Regulation can pre−specify parameter choice which can be helpful for company as well as for users. But, on the other hand, voluntary disclosure can allow companies to disclose more information through firm−specific (rather than pre−specific) parameter choices, both in written reports and in social interactions (see Hookana, 2003 ; Holland, 1998 ; Weetman and Beatie, 1999 ; Marston, 1999 ; Kinney, 2000 ; Ho and Wong, 2001).

6. Conclusions

It has been felt that existing disclosure requirements were not sufficient enough to report company risk information. And it was also felt that stakeholders should be properly informed about the risks of a company especially before and/or after investment decisions. As a result, ICAEW took the initiative to remove, or at least narrow down, the gap between a existing risk reporting practices and a desired level of risk reporting by stakeholders. Consequently, it issue several pronouncements to materialize its plan.

Companies used to report about risks at will and in their own preferred manner. They did even not really think about the issue from a users view point. They were used to disclosing risk information without considering whether it had a real predictive value or not, whether it was relevant or not, whether it was identified and measured properly or not and so on. The guidelines suggested by the ICAEW included ways to disclose risk information which were very helpful for users of annual reports. They advised disclosing the material risk information along with information about risk measurement systems, identification systems, what actions were to be taken against identified risks, and what the probable consequences of the risk to the business. ICAEW sees risk from a broader perspective and does not confin it only as threat to business. It considers the word ‘risk’ both as a threat and an opportunity. It advises quantifying risk where this can be done reasonab and cost effectively. It advocates voluntary risk disclosure as this will help a company to raise funds more easily from the capital market. More disclosure of risk information will show the transparency and efficiency of the management to

investors which will encourage confidence and investment in the company ; and as a result, the cost of capital should be lower. ICAEW also provides a risk matrix suggested by Arthur Andersen. It has also supported the risk matrix suggested by the Turnbull report for establishing a risk based internal control system.

The guidelines issued in the UK are really working as a pathfinder in the risk reporting arena. They give practical solutions to overcome long persisting problems in disclosing company information to stakeholders. Moreover, these guidelines can still be improved. For example, they suggest not disclosing commercially sensitive information as this can make a company vulnerable. But, this gives the management scope to hide something unwelcome to them. The quantification of risk is another problem. It is not always possible to quantify risk, and at the same time, there is no unique standard measure for measuring the risk of a company. The contradictory information need of different user groups is also a problem. The guidelines advise the disclosure of forward looking information. But, sometimes management do not want risk being blamed if some one suffers from the investment decisions based on the disclosed risk information. That is why the management may become conservative when quantifying risks and reluctant to disclose forward looking risk information. The other big issue is about the relationship between levels of risk disclosure and cost of capital. It is not yet been empirically tested that more risk disclosure will reduce the cost of capital. In conclusion, more research needs to be done to address these issues in order to make the risk disciosure guidelines more effective. In particular the relationship between levels of risk disclosure and costs of capital need to be examined empirically. It is also suggested that a risk measurement system and ways to protect commercially sensetive information be developed.

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Abbreviations

AAA–American Accounting Association
AICPA–American Institute of Certified Public Accountants
ASB–Accounting Standard Board
CICA–Canadian Institute of Chartered Accountants
FRED Financial Reporting Exposure Draft
FRS–Financial Reporting Standard
GAS–German Accounting Standard
GASB–German Accounting Standard Board
ICAEW–Institute of Chartered Accountants of England and Wales
OFR–Operating and Financial Review
SSAP–Statements of Standard Accounting Practice
UK–United Kingdom
USA–United States of America

The UK Guidelines for Company Risk Reporting−An Evaluation

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The study attempts to analyze the ins and outs of the risk reporting guidelines in UK. The guidelines advocate for the voluntary adoption of risk reporting through annual reports of the company. This voluntary reporting of risk will ensure the transparency and efficiency of the company management that eventually help the company to obtain funds from the capital market with the possible lowest cost. They also advise to disclose material / relevant risk information in a proper way so that the users can take their economic decision based on those disclosed information. On the other hand, company need not to disclose the commercially sensitive risk information, as it can give advantage to the rival companies. This risk reporting guidelines are also having some weaknesses. Such as, they mention about inverse relationship between level of disclosed risk information and cost of capital without any empirical evidence. Guidelines give a vague direction about the commercial sensitive risk information because companies can hide some important risk information on the ground of commercial sensitivity if needed. Other lacking include unavailability of suitable / reliable risk identification and measurement tools, expectation about common knowledge and so on.