

Reporting Risk - Where do you draw the line?

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“There are always two parties – the party of the past and the party of the future, the establishment and the movement” – Ralph Waldo Emerson

1.0 Introduction

With the advent of the Australian and New Zealand Risk Management Standards AS/NZS 4360:1999, the Institute of Directors Best Practice for New Zealand Directors 2001/2 and the development of Sustainable Development Reporting, there has been an increased emphasis on reporting economic, social and environmental risks. Top management clearly has a responsibility to ensure the organisation adopts a more unified and integrated approach to reporting and managing risk, but there are a number of practical implications. Although a large number of organisations have in place a process to comprehensively identify, describe, understand and manage risks, few have developed protocols to determine when risks should be made public, by whom and in what form?

This paper considers the issues from a broad perspective and then discusses two case studies. Attendees will gain an insight into the future of annual reporting, in particular current and possible future legal obligations, ethical and moral obligations and stakeholder expectations. In addition, delegates will be provided with the tools to examine their organisation's risk management and public reporting mechanisms.

2.0 Identifying Risk

Although the notion of reporting risk has been around for a long time, the first attempt at providing a generic framework for establishing the context, identification, analysis, evaluation, treatment, monitoring and communication of risk did not occur until 1995 with the Australian and New Zealand Risk Management Standards AS/NZS 4360:1995. This standard was later reviewed and the 1999 version was published under the reference AS/NZS 4360:1999.

This Standard is generic and independent of any specific industry or economic sector. It looks at risk as an interactive process that consists of well-defined steps. Risk management, unlike what the term suggests, is as much about identifying opportunities as avoiding or mitigating losses.

In order to discuss the process, it is valuable to clearly understand the meanings of key terms used in the risk management process as defined in the AS/NZS 4360:1999.

Event: an incident or situation, which occurs in a particular place during a particular interval of time

Risk: The chance of something happening that will have an impact upon objectives. It is measured in terms of consequences and likelihood.

Risk Identification: the process of determining what can happen, why and how.

Risk Management Process: The systematic application of management policies, procedures and practices to the tasks of establishing the context, identifying, analysing, evaluating, treating, monitoring and communicating risk.

Stakeholders: those people and organisations who may affect, be affected by, or perceive themselves to be affected by, a decision or activity.

The Risk Management process is outlined in Figure 1 below.

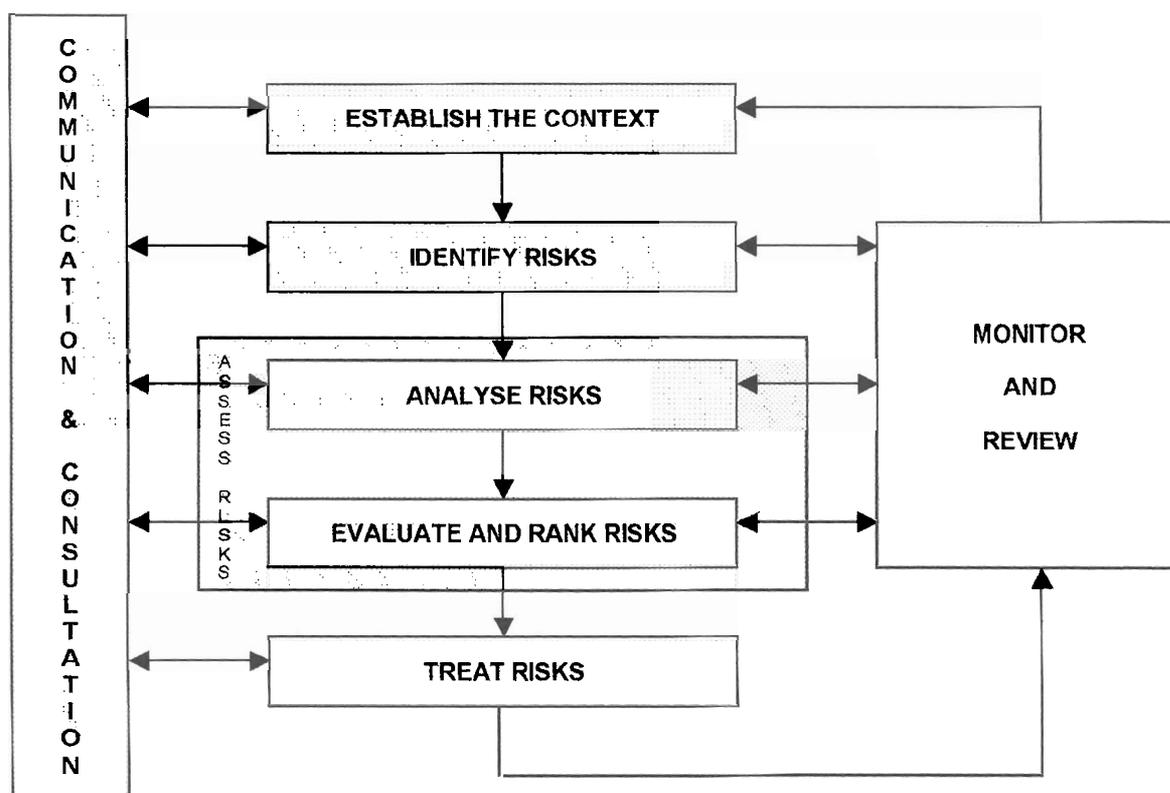


Figure 1: Risk Management Overview AS/NZS 4360:1999

3.0 Describing and Understanding the Nature of the Risk

There are five key characteristics of a risk that determine the nature of the risk. These are its probability, magnitude, burden, irreversibility and uncertainty. These are discussed below.

The probability of the risk occurring is a significant issue in that a large number of events obviously compound the net result, but the underlying significance is driven by the magnitude of all the combinations and permutations of events over time.

Magnitude lies at the heart of risk management. When combined with uncertainty, the magnitude of the effects becomes a guessing game that, if played by a combination of optimists, realists and pessimists, should lead to further research and a better end decision. The role of the risk manager is then to make sure the hard questions are asked and answered, such as "What is the worst-case scenario?"

At any point where the negative effects may cross over and affect the public, be it neighbour, consumer, the environment etc, it is essential that the probability and magnitude of benefits be also evaluated. No right-thinking person takes a risk for zero benefit, which is why the burden (ie, 'who bears the risks') is a key element in understanding the nature of the risk.

Understanding who bears the burden of the risk is both difficult and complex, largely because individuals and companies evaluate harm differently and effects often take a long time to appear and/or prove. An underlying concern however, is the gap between the risk being identified and the risk being reported. The longer the organisation, industry or country takes to inform the public of a risk, the higher the probability that stakeholders will lose faith in the entity.

Tobacco is a case in point. The link between tobacco and cancer was identified as early as 1953 by Dr. Ernst Wynder. He took pure tobacco tar collected from a smoking machine and painted the resulting tar on to the shaved backs of mice. After one year, more than half the mice had developed malignant tumours (Zegart, 2001). The international reaction was at best slow. Further research into the link did finally occur, but it was not until 1974 that the NZ government required warning labels be placed on cigarette packets. It then took considerably longer for the law to recognise the risks to the second-hand smoker. This occurred in 1990 with the introduction of the Smoke-Free Environments Act 1990.

Whether a risk is irreversible is about the ease with which those harmed can return to the status quo. This is a key driver in the debate on the release of genetically engineered plants, animals and insects. For example, genetically engineering infertility into possums.

Lastly, there is a need to scope out the degree of uncertainty. This involves trying to develop a view as to (1) what you know, (2) what you think we know, (3) what you know that you do not know and (4) what you do not know, that you do not know. The uncertainty in a risk assessment changes with time as information develops (Molak et al., 1996). Obviously, where experts disagree, further research is the only solution. In general, as the degree of uncertainty increases, the more likely the precautionary approach should be applied. Table 1, outlines very subjectively, how these characteristics could fall in relation to four different sources of risks.

Table 1 Nature of the Risk

Characteristics of Risk	Tobacco	Vehicle Emissions	GMO's in the Outdoors	1080
Probability	Medium	Medium	Low	Low
Magnitude	High	Medium	High	Medium
Who bears the risk	Primary Smoker Second-Hand Smoker	Primary Second Hand	Public	Public
Ability to Reverse Effects	No	No	No	No
Level of Uncertainty	Low	Medium	High	Medium

Source: The Art behind the Science: McGuinness

4.0 Managing Risks

In many situations, preparers of reports not only need to identify the risk (the event), but also need to report on the possible effects and how those events and effects will be managed. For example an organisation that is aware of a risk that underground pipes may be cracked, may also report on how they will manage the event (e.g. the broken pipe) and the potential effects (e.g. the leaking liquid). In this example, this may include reporting on frequency and magnitude of soil tests, reporting the results of those tests, advising stakeholders of disaster plans (e.g. evacuation plans) and how, when and where new pipes will be installed.

Often the challenge is not identifying the risk but developing systems of managing the risk. This is largely due to the high degree of judgement and the range of expertise necessary to determine an effective system of risk management. One of the key challenges is trying to reach a concensus on the level of risk tolerable by an organisation and the wider community. How to make the judgement of what and how this information on risk should be reported is discussed in the next section.

5.0 Reporting Risks to the Public

In Figure 1, the communication of risk is key to an effective risk management process. However in order to complete this process, professional judgement must be applied to ensure all significant information is reported and that the information is reported in a timely, accurate and comprehensive manner.

In New Zealand, the reporting of risk in the public arena can be divided into 'action-reaction' reporting and 'business as usual' reporting.

Action-reaction reporting is triggered by a significant unexpected event, like a spill, explosion that lead to health risks and/or pollution, or unexpected deaths (for example the recent health scare in Dunedin).

'Business as usual' reporting, is the reporting of risk at one point of time usually on a regular basis, for example at board meetings or in the annual reports. In this case, not only is the entity reporting on past events of significance (action-reaction reporting) but all other significant risks to the entity both in the past and in the future. Examples could include waste disposal, health and safety standards, climate change, substantial increases in the costs of raw materials and rising interest rates.

The remainder of this paper will focus on annual reports and what is called 'business as usual' reporting. In my view there are a number of questions that must be asked in order to determine if the information should be included in the annual report.

(1) Is the risk significant?

In order to determine what must be included in annual reports, preparers must develop an understanding about what stakeholders consider is significant. This ties in directly with the concept of "materiality" that is a core concept underlying the Statement of Concepts.

Materiality is based around the concept of the degree the information is likely to influence users of financial reports in making decisions or assessments.

Determining the materiality of an item is essentially a matter of judgement. Materiality is concerned with assessing whether omission, misstatement or non-disclosure of an item of relevant and reliable information could affect the perceptions of financial reports users. Materiality applies to non-financial and narrative information as well as to the financial contents of general purpose financial reports. Statement of Concepts 6.6.

In making this assessment, preparers should consider the nature of the risk through the eyes of stakeholders. In particular what is the stakeholders 'appetite for risk' in regard to the probability, magnitude, who bears the risk, the ability to reverse effects and the degree of uncertainty. For example: GE SC Simon

(ii) Preparers should be conservative

If the nature of the risk is significant, preparers should apply the concept of prudence. This is not unlike the precautionary approach adopted in the Resource Management Act and the Hazardous Substance and New Organisms Act.

The concept of prudence (or conservatism) is outlined in the Institute of Chartered Accountants Statement of Concepts.

"The preparers of financial reports have to content with the uncertainties that inevitability surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur... Prudence requires that preparers exercise a degree of caution in making the estimates necessary to

recognise such transactions and events, to ensure that assets or revenues are not overstated and liabilities or expenses are not understated. However the exercise of prudence does not allow the deliberate understatement of assets or revenues,...or the deliberate overstatement of liabilities and expenses. Clearly such a misinterpretation is incompatible with the notion of 'representational faithfulness'." Statement of Concepts 1993 clause 6.9

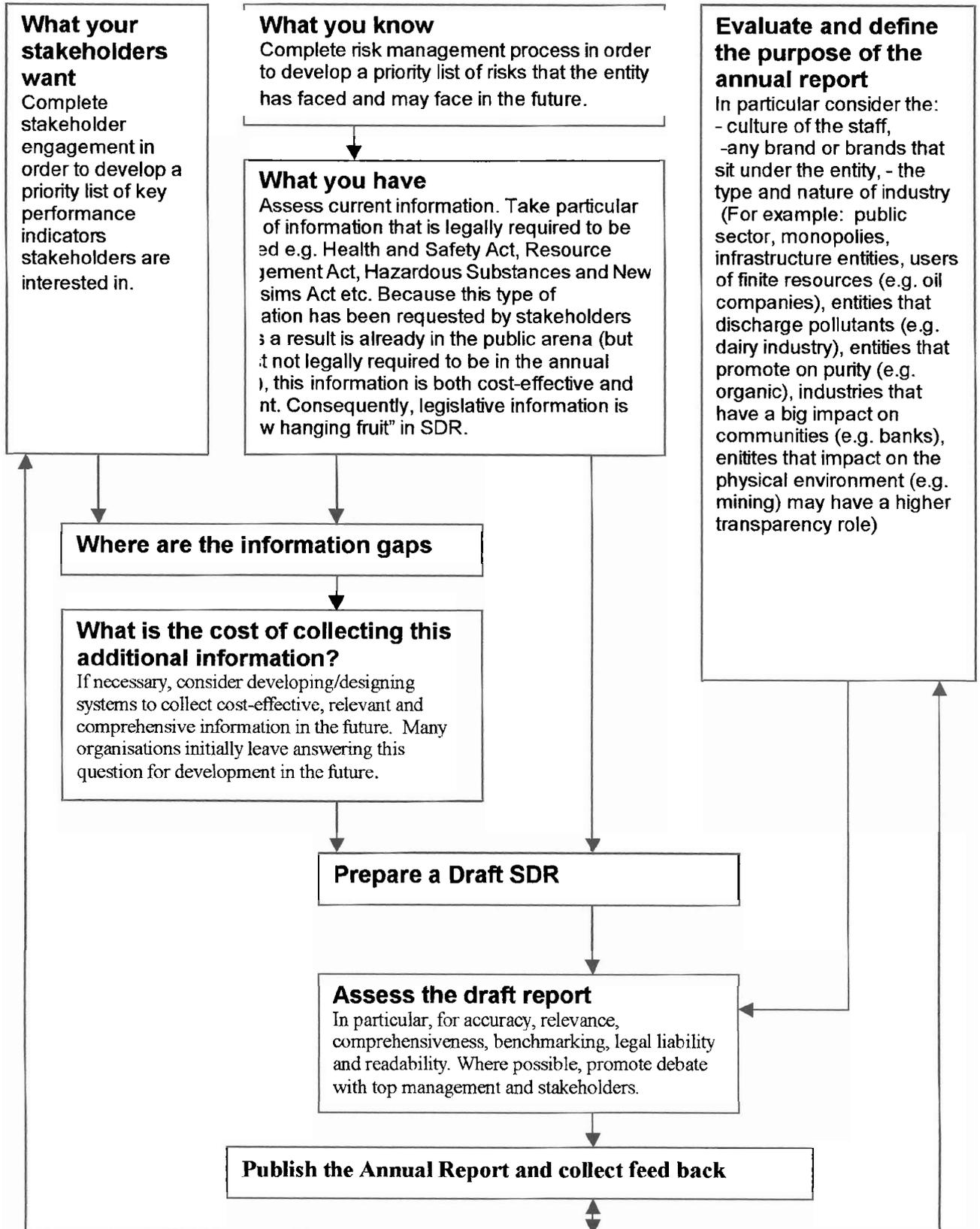
(iii) Preparers should ensure Representational faithfulness

Representational faithfulness is achieved when transactions and events, which affect the entity, are presented in financial reports in a manner that corresponds with the substance of the actual underlying transactions and events. That is, transactions and events are accounted for and presented in a manner that conveys their economic effect rather than necessarily their legal form." Statement of Concepts 4.10

Consequently, although the reporting of risks fits within current conceptual framework, the interpretation of risks by stakeholders and therefore preparers has broadened significantly in the last ten years. For example, risk management acknowledges is that events and the effects resulting from events are both critical, for example if heavy rains cause flooding and the flooding spread disease, the heavy rain is the event, the subsequent effects are the flooding and the disease.

For preparers of financial accounts, this broader definition requires a higher degree of professional judgement. In order to make the best decisions on what should be reported, preparers should adopt what I call, the SDR Framework.

Figure 2: Framework for Sustainable Development Reporting



Evaluate and define the purpose of the annual report

In order to define the purpose of the annual report, two things must occur. Entities need to define the entity in detail and secondly, preparers and verifiers need to determine the level of assurance they wish to adopt.

(i) Preparers need to define the boundaries of the entity

This task may look easy but in fact can prove very difficult.

There are currently a range of SDR's in the market that fail to provide a clear definition on what they are reporting on, however the problem of definition and the degree of assurance are not new to preparers and verifiers of conventional reports. These points are discussed in terms of conventional reports and those reports that are moving towards SDR.

(a) Conventional Reports

Conventional financial reports, adopt terminology like "a true and fair view of the financial position", but do not define the boundaries they are reporting upon, nor do they provide specific information on the degree of assurance and materiality. These are largely judgement calls made by preparers and verifiers, based on the principle based approach which is discussed in the Statement of Concepts and Standards which are periodically issued by the Institute (ICANZ). The principles are not legislated, although the function of the Institute is enacted in law under the "Institute of Chartered Accountants of New Zealand Act 1996."

Functions of the Institute – The functions of the Institute are –

- (a) To promote quality, expertise, and integrity in the profession of accountancy by its members in New Zealand:
- (b) To promote, control, and regulate the profession of accountancy by its members in New Zealand:
- (c) To promote the training, education, and examination of persons practicing, or intending to practice, the profession of accountancy in New Zealand or elsewhere:
- (d) Any other functions that are conferred on by its rules. Institute of Chartered Accountants of New Zealand Act 1996 - Section 5."

As a consequence, verifiers tend to alert readers of what they have done in regard to "assurance" and the "level of accuracy (materiality)" they are prepared to vouch for. For example normal audit reports can include statements like: "we have planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give a reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error."

Conventional financial reporting has already moved its boundaries over the last 100 years. It has moved from (A) cash accounting to (B) accrual accounting – cash + provisions to (c) accrual accounting – cash + provisions + contingent liabilities.