

ACCOUNTANCY FUTURES

Predicting an uncertain future: narrative reporting and risk information

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ABOUT ACCOUNTANCY FUTURES

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This paper reviews the state of risk and business forecast information disclosure in narrative reporting. It is based on a review of annual reports from industry leaders in the UK, Germany, the US, Canada, Australia, Malaysia and Singapore.

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The Council of the Association of Chartered Certified Accountants consider this study to be a worthwhile contribution to discussion but do not necessarily share the views expressed, which are those of the authors alone. No responsibility for loss occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by the authors or publisher.

Executive summary

BACKGROUND

The latest recession was a general wake-up call. It has shown that the system, as it stands today, is no longer sustainable. Despite extensive regulation and reporting standards, some of the largest banks of the last century collapsed, not with a bang, but a whimper. The reasons for this are wide-ranging, but one important aspect is the fact that shareholders of these banks, as well as those of other companies, did not have the fullest possible information about risk and business forecasts.

It would be hard to believe that the risk of excessive sub-prime lending and the lack of forecast of flat-lining property prices were transparently disclosed, as these issues might have affected a company's share price. If annual reports are to achieve their objective of giving the reader a view of the company 'through management's eyes' this information should have been disclosed. At the same time, it could also be an issue with the users of the information themselves; an exclusive 'trust in numbers' might generate a disregard for any possible narrative warnings, such that they were unaware of some of the current issues facing the companies, which may not be quantifiable, but may still be key to estimating the future value of a company's stock or share price.

If these narrative passages do not disclose risk and business forecast information in a sufficiently transparent manner, they will continue to be of little benefit to users, as this obscurity will sustain their 'trust in numbers'. For users to have access to the fullest information possible, therefore, quantitative risk information will not suffice; more qualitative risk information, whether it places quantitative risk information in context or not, is necessary.

More information on these and other narrative reporting issues can be found in the report of the joint Deloitte–ACCA international survey of CFOs' views on narrative reporting, entitled *Hitting the Notes, But What's the Tune?* (ACCA 2010).

THE STUDY

A study of the risk information contained in the narrative reporting of annual reports was conducted in 2010. Annual reports of the industry leaders from five industrial sectors and seven countries were analysed.

The industrial sectors from which the leading companies were selected were banking, chemical production, food production, oil and gas production, and general retail. The countries were the UK, Germany, the US, Canada, Australia, Malaysia and Singapore. As well as the annual reports of companies operating in the above sectors and countries, six dual-listed companies' annual reports were also selected for the survey.

The analysis of the annual reports of companies across jurisdictions and industries gives a balanced view of the current state of disclosure, and enables the understanding of the many influences affecting narrative disclosure.

THE FINDINGS

Overview of risk-information disclosure

Legal requirements and voluntary guidance shape much of the disclosure information within annual reports, but some companies go further than the legal requirements. This perhaps signals a more extensive consideration of the companies' risks and future prospects by its management.

More specifically, the disclosure of risk information follows two main tendencies: one for financial risk, and the other for non-financial risk. Of course, these two types of risk are separate; the main difference being that one can be quantified easily, while the other cannot. Financial risk information assists the reader of an annual report in assessing the financial statement and other quantitative information within the annual report. Non-financial risk information cannot be quantified, but can be described by making use of narrative sections of the annual report (in particular the 'first half'). Non-financial risk information has no direct bearing on the quantified information found in the annual report's financial statements, but still discloses risks that may affect the company far beyond its balance sheets.

Financial risk information

Financial risk information is generally disclosed in line with the requirements of IFRS, even where IFRS is not yet mandatory, particularly for the most important and common financial risks: credit and market risk. These types of risk are disclosed in more or less detail across every jurisdiction and every industrial sector, with very few exceptions. This is not coincidence, as disclosure on these types of financial risk is a legal requirement in all jurisdictions. Disclosure on liquidity risk is required by IFRS, so all companies based in IFRS-adopting countries do disclose this information. On the other hand, those countries that have not adopted IFRS as such, but a more local adaptation, or indeed have no financial reporting standards, have tended not to disclose information on liquidity risk, which is probably one of the most important risks (particularly in this time of economic uncertainty, when the liquidity of funds between banks and companies has been a very important issue).

Non-financial risk information

Non-financial risk information disclosure, on the other hand, needs to follow less stringent standards, as IFRS is not applicable. This type of information disclosure actually follows much more localised requirements and guidance, although these do tend to have some similarities. As a result, the observations made regarding the disclosure of this information in companies' annual reports are much less general than those for financial risk. Non-financial risk information tends to be disclosed to a lesser extent in Asian and Australian companies' annual reports, however, when compared with those prepared by companies based in the West.

Regulatory risk information

This is particularly noticeable in the case of regulatory risk information (the most disclosed non-financial risk information type), and legal risk information. More generally, external risk information (including regulatory risk information), like most non-financial risk information, is disclosed most extensively again in the West, although some variability is found in the content of the risk information.

Sustainability risk information

Another extensively disclosed type of risk information is about sustainability risk; in this case, European companies have a stronger tendency to disclose this information in their annual reports, whereas the companies based in other jurisdictions, even the US, do not. Despite the same legal requirements across Europe, disclosure of some risk information, in this case personnel risk, is not uniform across companies' annual reports, which indicates that legal requirements are not necessarily sufficient to ensure comparability between annual reports prepared by companies based in different jurisdictions.

Business forecast information

Disclosure of business forecast information, which is frequently found under a specific section within the annual report's 'first half', is a different animal altogether; all jurisdictions, except for Malaysia and Singapore, legally require the disclosure of forward-looking information. This may suggest some uniformity across disclosures, which there is, as almost all companies disclose this type of information in the annual report (two US, one Australian, one Malaysian, and one Singaporean company are the only ones not to disclose forward-looking information within a designated section). For companies based in the Far East, business forecast information has a tendency to be part of the chairman's or the chief executive's statement. In the West, however, particularly in Europe, and especially in Germany, business forecast information is disclosed within a different chapter of the annual report's 'first half'. This business forecast information can address different business segments, or indeed vary between a general and a specific approach, but the disclosure always tends to be more extensive than for companies based in the Far East.

1. Recent international trends and developments

In February 2011, the Financial Reporting Review Panel of the FRC expressed concerns about how companies are reporting the principal risks and uncertainties facing their business. The Panel opines that risk disclosure taking place in the director's report does not clearly explain the principal risks and uncertainties facing the businesses and/or how the businesses are managing the risks and uncertainties.

A number of surveys have been conducted by both corporate and public bodies, analysing the current state of risk and business forecast reporting in annual reports. Deloitte, PricewaterhouseCoopers and KPMG have each conducted surveys of narrative reporting practice, while others have been carried out by the Accounting Standards Board (ASB), International Accounting Standards Board (IASB) and other bodies of a public nature. Table 1.1 lists the surveys considered here and their principal findings on risk and business forecast reporting.

RISK REPORTING

The narrative reporting of risk information within annual reports involves the disclosure of all principal risks that a company faces in the day-to-day operation of its business. These risks can be categorised in many different ways, but the reporting of them tends generally to follow two distinct axes. First, the reporting of financial risk tends to complete the financial statements, and contains a significant amount of quantitative information. In contrast, the reporting of non-financial risk involves the exclusively qualitative description of risks that cannot be quantified, and therefore cannot (and do not) have any relationship to the financial statements themselves, but more generally to the company as a whole.

BUSINESS FORECAST REPORTING

One of the functions of a (good) annual report is to assist the user in gauging the future profitability of a company. Through the disclosure of information about the future prospects for the company's business, the report gives users some idea of the level of value creation to expect within the business. Disclosure of this type of information is known as business forecast reporting. This type of narrative provides forward-looking information about the company's business, which is aimed at various types of annual report user.

Table 1.1: Risk reporting and business risk reporting

Author	Year	Title	Risk reporting	Business forecast reporting
Deloitte	2009	<i>A Telling Performance</i>	96% of companies describe principal risks and uncertainties faced.	95% of companies include discussions about the future.
			Eight risks disclosed, on average, by each company.	Only two companies linked previous predictive information with subsequent actual events.
			63% of companies identify the state of the economy as a key risk.	
PwC	2007	<i>Corporate Reporting – A Time for Reflection</i>	Some success but reporting needs ‘enriching’.	Business leaders do not wish expectations to equate to profit forecasts.
				Business leaders do not want commercially sensitive information to be disclosed.
KPMG	2008	<i>International Survey of Corporate Responsibility Reporting</i>	63% of G250 companies disclose information on risks in the supply chain.	n/a
			57% of G250 companies disclose climate change as a business risk.	
			More disclosure of this type of risk information needed.	
ASB	2006	<i>A Review of Narrative Reporting by UK Listed Companies in 2006</i>	Principal risks and uncertainties should be enumerated instead of giving a long list.	‘A number of companies have been assessed as providing good disclosures in this area.’
			Large range of risks disclosed (up to 33 types).	One company disclosed details concerning forecast demand and planned capital investment.
	2008/9	<i>A Review Of Narrative Reporting by UK Listed Companies in 2008/2009</i>	Lack of detail, generic nature.	20% of companies ‘discussed...relevant trends and factors with a true forward outlook’.
			Risk disclosure not of good quality or organisation.	Narratives include mostly very general statements and lack any proper supporting evidence.

2. Survey results: key findings

FINANCIAL RISK INFORMATION

Financial risk represents the additional risk faced by a company when it uses debt as well as equity to finance its operations. Two broad types of financial risk exist: credit risk and market risk. These two types of financial risk can then be divided into more specific risk categories. One example of a specific type of credit risk is cross-border or country risk. On the other hand, 'market risk' groups together many specific risk categories: foreign exchange risk, interest rate risk and equity price risk. Liquidity risk is also a specific risk which is sometimes considered as a type of market risk. Much financial risk disclosure is required by law, yet despite this such disclosure can be seen to be somewhat varied across annual reports.

Legal requirements

Many legal requirements govern the reporting of financial risk information, as this information must be disclosed in many cases both in the 'first half' of the annual report and in the notes to the financial statements. The legal requirements or, in some jurisdictions, voluntary guidelines that are followed for the disclosure of financial risk information are summarised in Table 2.1 below.

Overall, disclosure of financial risk is legally required in every jurisdiction within the sample. The amount and detail of disclosure legally required within each country varies somewhat, but only the presence or absence of particular types of risk information will be evaluated in this survey.

Financial risk-disclosure requirements are similar across most countries in the sample. Although small differences arise from the different degrees of IFRS adoption, most if not all countries require, at least, the disclosure of credit and market risk information.

Table 2.1: Legal requirements for disclosure of financial risk information

Jurisdiction	IFRS required?	Which standard or other requirements exist?
UK and Germany	Yes	IFRS 7: credit risk, market risk including currency, interest rate and other price risks, and liquidity risk
US	No	Section entitled 'Item 7A – Qualitative and Quantitative Disclosures about Market Risk' US-GAAP: 'Loss and gain contingencies, risk and risk management associated with financial instruments, significant risks and uncertainties in estimates and risk concentrations with potentially severe impact on the entity/arising from major customers' (Dobler 2005).
Canada	No	CICA Guidance:* price risks, including foreign currency risk, interest rate risk, and market risk
Australia	Yes	A-IFRS** credit risk, market risk including currency, interest rate and other price risks, and liquidity risk (AASB 7)
Singapore	Yes	FRS 32† credit risk, market risk including currency, interest rate and other price risks, and liquidity risk
Malaysia	No	FRS 7†† market risk, including interest rate risk, commodity price risk, foreign exchange rate risk or index of prices or rates

* Updated in May 2004, following the adoption of National Instrument 51-102, Continuous Disclosure Obligations, in December 2003.

** http://www.aasb.gov.au/admin/file/content105/c9/AASB7_08-05_COMPOct08_07-08.pdf

† FRS 32, *Financial Instruments: Disclosure and Presentation* http://www.asc.gov.sg/frs/attachments/2004/FRS_32_2006.pdf

†† MGAAP: FRS 7, *Financial Instruments: Disclosure* http://www.masb.org.my/index.php?option=com_content&view=article&id=1261

Overview of disclosure

As a result of the similar legal requirements and guidance across all jurisdictions, it is no surprise that all companies' annual reports disclose risk information on both credit and market risks. The annual reports of the companies in the sample disclose financial risks fairly uniformly – credit risk and market risk information is always disclosed, as mentioned before, liquidity risk information is almost always disclosed, and finally pension risk and tax risk, which are disclosed in fewer than one-third of the annual reports analysed.

Market risk is not named as such in every case (except in the banking sector's annual reports). Regardless of country and sector, all companies disclose some kind of market risk information within their annual report. In a sense, market risk information is, with credit risk, the most disclosed type of financial risk information. For example, in the annual report for Marks and Spencer (M&S), no reference is made to market risk itself, although information concerning the different types of market risks is disclosed:

[The] Group treasury also enters into derivative transactions, principally interest rate and currency swaps and forward currency contracts. The purpose of these transactions is to manage the interest rate and currency risks arising from the Group's operations and financing.
(Marks and Spencer plc 2010)

The risk information disclosed above gives the user an idea of how these types of market risk are mitigated through the use of derivative transactions. This type of statement is common to many of the annual reports in the sample – it is in fact a legal requirement in most jurisdictions.

Overall, commodity price risk information is disclosed more often than equity price risk information, particularly in the case of oil and gas production, food production, and that of dual-listed companies.

Information on credit risk is also a legal requirement in most jurisdictions, therefore many annual reports disclose somewhat similar credit risk information, as can be seen below for the Australian chemical producer and its German counterpart, respectively.

The Consolidated entity has a credit policy under which each new customer is analysed individually for creditworthiness before the Consolidated entity enters into any sales transaction on an open credit account with standard payment, delivery terms and conditions of sale.
(Incitec Pivot 2009)

We lower credit risks for our financial investments by engaging in transactions only with business partners and banks with good credit ratings and by adhering to fixed limits. (BASF 2009)

Although it is explained in a different manner, this type of risk information is disclosed across these two annual reports, and indeed all the reports in the sample.

The main type of risk, which is always disclosed except in the US, where the legal requirements are slightly different, is liquidity risk information. This type of risk information, according to the IFRS, must be disclosed. Despite this, different companies disclose this risk in varying amounts of detail. The annual report for Malaysia-based PPB Group discloses liquidity risk information as follows.

Liquidity risk is the risk that the Group will not be able to meet its financial obligations when they fall due.

The Group's exposure to liquidity risk arises principally from its various payables and borrowings.

The Group seeks to ensure all business units maintain optimum levels of liquidity at all times, sufficient for their operating, investing and financing activities.
(PPB Group 2009)

Despite not yet having adopted IFRS, and not requiring liquidity risk disclosure as such in the 'first half' of the annual report, all Malaysia-based companies disclose this type of risk information. The requirement for IFRS provides increased detail in the disclosures, as is seen in the annual report of Singapore-based Wilmar International, a company both operating in the same industrial sector and based in the same geographical region as PPB Group.

Liquidity risk is the risk that the Group will encounter difficulty in meeting obligations due to shortage of funds. The Group maintains sufficient liquidity by closely monitoring its cash flow. Due to the dynamic nature of its underlying business, the Group adopts prudent liquidity risk management policies in maintaining sufficient credit

facilities, including the use of trade finance for the Group's raw material purchases. The Group also aims at maintaining flexibility in funding by keeping credit facilities available with different banks.
(Wilmar International 2009)

The requirement for IFRS has resulted in more detailed disclosure of liquidity risk, ensuring that the user is aware of the various facets of this type of risk and its mitigation within the company. In fact, the lack of liquidity in the private sector is now known to be one of the major causes of the latest economic crisis.

The lack of IFRS requirements, however, can result in the complete failure to disclose liquidity risk information, as is the case for two of the sample companies based in the USA: the only two companies in the sample, in fact, that fail to disclose any liquidity risk information. These two companies also happen not to disclose commodity and equity price risk information. US companies are not required to follow IFRS, and US-GAAP does not specify precisely the type of risk information to be disclosed, unlike the legal requirements of other countries, or indeed IFRS.

'Unusual' financial risk information, such as that about pension or tax risk, is the only type of disclosure commonly missing from annual reports. More than one company actually discloses both these risks in the annual report; the companies that do disclose this information tend to be based in the West and operate in the banking, chemical production or food production sectors.

As a multinational corporation, our operations are subject to additional risks.... Discriminatory fiscal policies... Changes in tax laws and the interpretation of those laws.
(Kraft Foods 2009)

Volatility in the equity markets or interest rates could substantially increase our pension costs and have a negative impact on our operating results and profitability.
(Kraft Foods 2009)

For US-based Kraft Foods, pension risk information is disclosed within its own section, whereas tax risk information is disclosed within the context of multinational corporate exposure, as can be seen above. The disclosure of information on these types of risk is more detailed and clearer within the annual report prepared by UK bank, HSBC.

HSBC is subject to tax-related risks in the countries in which it operates, which could have an adverse effect on its operating results. (HSBC 2009)

HSBC operates a number of pension plans throughout the world, as described in Note 8 on the Financial Statements. Some of them are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme. (HSBC 2009)

The relative lack of disclosure on the above types of risk can be attributed to the fact that it is not required, as such, by IFRS, but these risks are still part of the risk profile of many companies. As a result, the information is disclosed anyway, because some countries in the sample do require the disclosure of all risks facing the company, whether financial or not.

Generally, companies adhere to legal requirements for disclosure of financial risk information. Even so, most companies' annual reports stick to their jurisdiction's minimum required disclosure of financial risk. The fact that two US companies failed to disclose some financial risk information reveals that US reporting requirements need to converge with IFRS requirements so as to improve disclosure of financial risk in the annual reports of US-based companies. Furthermore, few annual reports venture beyond these requirements by disclosing information concerning other types of financial risk that the company faces, showing that, without mandatory requirements, perhaps not all risks are appropriately analysed. At the same time, the non-mandatory nature of other disclosure of financial risk information enables certain companies to show that they are ahead of the rest, in terms of the trust the users can have in the information that is disclosed.

NON-FINANCIAL RISK INFORMATION

Non-financial risk information can be defined as information concerning any risk other than financial, in other words, any risk that does not threaten the adequacy of the company's cash flow in meeting its financial obligations. These are wide-ranging, and sometimes specific to a country, industry or company. The principal types of non-financial risk information disclosed within the annual reports of companies in this survey's sample are external risk, operational risk, strategic risk and sustainability risk information.

Legal requirements

The statutory requirements regarding disclosure of non-financial risk information are somewhat different from those for financial risk information; non-financial risks are always disclosed within the 'first-half' of the annual report as they do not contain any quantitative information (which tends to assist in the reading of financial statements). As a result, the requirements for this type of risk disclosure are somewhat different, whatever the jurisdiction.

Table 2.2: Statutory requirements for disclosure in different jurisdictions

UK and Germany	'the directors' report for a financial year must contain: a fair review of the business of the company, and a description of the principal risks and uncertainties facing the company'. (PricewaterhouseCoopers 2010)
US	Item 1A – Risk factors US-GAAP: 'Loss and gain contingencies, risk and risk management associated with financial instruments, significant risks and uncertainties in estimates and risk concentrations with potentially severe impact on the entity/arising from major customers.' (Michael Dobler 2005)
Canada	None
Australia	'significant risks and uncertainties facing the company, its core businesses and segments, the strategies and processes applied for managing those risks and the potential impact of these risks on financial performance'. (G100 2003)
Singapore	None
Malaysia	None

Overview of disclosure

There exists a tendency for non-financial risk information to feature more frequently in European and North American companies' annual reports than in Asian and Australian companies' annual reports.

The type of non-financial risk most commonly disclosed across the annual reports of the companies in the sample is regulatory risk, which sometimes also includes legal risk.

An annual report that includes a good example of this type of disclosure, including information on both legal and regulatory risk, is that prepared by Unilever.

Unilever is subject to local, regional and global rules, laws and regulations, covering such diverse areas as product safety, product claims, trademarks, copyright, patents, employee health and safety the environment, corporate governance, listing and disclosure, employment and taxes. (Unilever 2009)

The companies that do not disclose information concerning regulatory or legal risk tend to be based in the Asian and Australian markets, and in the former their lack of disclosure may result from a lack of legal requirements for non-financial reporting. This is a valid observation across sectors, and includes even annual reports prepared by companies in the banking sector. This may be applicable for disclosure of other non-financial risk information.

External risks disclosed in the annual reports of the sampled companies range from political and economic risks to regulatory and legal risks (referred to above). These types of risk are almost always disclosed, particularly in the annual reports prepared by companies based in the West, whatever industrial sector the company operates in. The 10-K filing for Dow Chemical, based in the US, features some disclosure regarding several external risks, as shown in the following excerpts from the company's annual report.

The Company is party to a number of claims and lawsuits arising out of the normal course of business with respect to commercial matters, including product liability, governmental regulation and other actions.

Adverse conditions in the global economy and disruption of financial markets could negatively impact Dow's customers and therefore Dow's results of operations.

Weather-related matters could impact the Company's results of operations. (Dow Chemical 2009)

The three disclosures above, featured within the 'risk factors' section, give a summary explanation of the risk, and then describe the mitigating activities within a paragraph following each one-sentence description. The first disclosure addresses legal and regulatory risks, the second disclosure is on economic risk and the final one concerns weather-related risks facing the company. These are not organised into categories, as is done in many Europe-based companies' annual reports.

The way that the risks are disclosed is somewhat different for UK-based companies' annual reports, and indeed for those of German-based companies (as companies in both countries have to follow the same requirements for the reporting risks that they face).

Regulatory and political risks: Due to the European chemicals directive REACH, which came into force on June 1, 2007, BASF and our European customers face the risk of being placed at a disadvantage to our non-European competitors due to the cost-intensive test and registration procedures. (BASF 2009)

The Germany-based BASF discloses precisely the category/type of risk information it is analysing, as above, enabling fast reference for the user, particularly if only particular types of risk are of interest to that user. This is similar to non-financial risk information disclosure for UK-based companies' annual reports, as shown below for economic risk:

Economic Outlook

Poor outlook for the UK and global economy impacts our ability to deliver our market share and margin ambitions

Regular review of pricing, promotion and marketing strategies for appropriateness and their ability to adapt to a changing consumer market

Ongoing close working with suppliers to help them take cost out of their supply base

Adapting product ranges to meet changing customer needs. (Marks & Spencer 2010)

One important difference is in the nature of the information supplied: UK-based companies give non-financial risk information in very concise, simplified terms, often making use of bullet points, whereas in the German companies' annual reports there is more depth in the analysis and disclosure of such information.

One of the other most frequently disclosed types of non-financial-risk information is sustainability risk. This type of risk is often disclosed under the heading of environment risk, but other headings are sometimes used. Annual reports that name sustainability itself as a risk tend to be prepared by companies based in Europe; no single-listed US-based company discloses sustainability risk, even within sectors where sustainability is a principal risk, ie chemical and oil and gas production. For example, BASF discloses the following information within the risk report:

Sustainability: BASF is committed to integrating environmental protection and socially responsible conduct into its business activities. Contraventions to our voluntary commitment to sustainability or to laws represent a reputational risk and could lead to operational or strategic risks. We have set up a global issue management system for sustainability to enable us to promptly recognize risks and opportunities related to sustainability. (BASF 2009)

Although not named as such, Dow Chemical discloses similar information, only here the focus is on the link between the environment and law, litigation and regulation, not sustainability, although this could be implied. In the extract below, the disclosure focusing on the link with regulation is outlined:

Increased concerns regarding the safety of chemicals in commerce and their potential impact on the environment have resulted in more restrictive regulations and could lead to additional regulations in the future. (Dow Chemical 2009)

As a result of the legal requirement to disclose risks facing the company in the 'first part' of European companies' annual reports, sustainability risk information is more frequently disclosed than across the Americas, as well as across South-East Asia and Australia. Of course, the banking sector, which does not produce, manufacture, or distribute goods, is much less likely to face any sustainability risk than the other sectors analysed.

Like sustainability risk information, risk information relating to personnel is seldom disclosed in annual reports, although this tends to be a valid principal risk regardless of sector or jurisdiction. Nonetheless, as with sustainability risk, this information is disclosed only within the more 'complete' annual reports. In this sense, only some European companies disclose this type of risk information, as the legal requirements are stricter within these jurisdictions. Nonetheless, some other companies, such as Walmart, based in the US, face considerable personnel risk, and therefore this information does get disclosed, although more rarely.

The following extract from BASF's annual report reveals the link between the company's personnel and its 'sustainable success':

Personnel: Dedicated and competent employees are essential for BASF's sustainable success. Our goal is to form the best team in industry. Due to global competition for highly-qualified specialist and management candidates, which is intensified by demographic change, there is a risk that job vacancies cannot be filled with suitable applicants, or only with a significant delay. (BASF 2009)

The information disclosure closely follows the legal requirements, giving all the necessary information for the user to evaluate the importance of this principal risk on the success of the company's business. Despite operating in a different sector, but based in the same country, Metro's disclosure is almost exactly the same as that for BASF.

Human resources risks: The expertise, dedication and motivation of our employees are key success factors that have a decisive impact on our competitive position. One prerequisite to achieve strategic goals are highly qualified experts and managers. It is an ongoing challenge to recruit and retain such valuable employees for the Group, in particular in the face of intense competition for the best people. (Metro 2009)

The similarity between the two disclosures is substantial, and indicates that the risk information disclosed may be generic; indeed the same risks regarding personnel attraction and retention face all companies, but the differences lie in how these risks are mitigated, and even the manner in which this information is disclosed. As can be seen below, the annual report for Marks and Spencer,

the UK-based general retailer, also includes disclosure of personnel risk information, simply entitled 'People'.

People

Failure to attract, develop and retain key employees (head office and stores) limits our ability to deliver our plans.

- *Formalised objective setting in place for all employees, including behaviours aligned to the M&S brand values.*
- *Lead to Succeed leadership programme underway to develop and fast track current and potential leaders.*
- *Learning and development opportunities available and promoted across all business areas.*
- *Bonus scheme in place for all employees based on business and individual objectives.* (Marks and Spencer 2010)

The use of bullet points to disclose this information conveys complex information in a clear and straightforward manner, enabling the user to obtain a quick overview. This results in a trade-off between the wealth of information given and the clarity of that information. This may be somewhat surprising because the same legal requirements apply in both countries via the EU Directives.

As demonstrated above, the same legal requirements do not imply the same degree of disclosure of risk information, in particular in the case of non-financial risks. Much more seems to affect the extent and nature of disclosure than the legal requirements alone. This may have far-reaching implications for the standardisation of narrative reporting of risk information, perhaps changing the focus of standardisation away from statutory requirements and more towards non-mandatory guidelines, particularly for non-financial-risk information appearing in the 'first half' of the annual report.

BUSINESS FORECASTING INFORMATION

The disclosure of business forecast information is an important part of the annual report; it helps users to evaluate the future prospects of the company's business, and helps, to some extent, to place the financial statements in context. Although the disclosure of business forecast information is useful to stakeholders, legal requirements are far from uniform across the jurisdictions in the sample. It follows that disclosure is also not necessarily uniform across the annual reports sampled.

Legal requirements

The statutory requirements for the disclosure of business forecast information in the annual report of companies for each jurisdiction are outlined in Table 2.3.

Table 2.3: Disclosure of business forecast information

UK	'The main trends and factors likely to affect the future development, performance and position of the company's business.' (Chivers 2007)
Germany	'Extensive analysis of development and performance of the business during the year, its financial position at the year-end, reporting of financial and non-financial key performance indicators, and the likely future development of the company including its significant opportunities and risks.' (IASB 2007)
US	'Provide information which enables investors to evaluate how likely it can be that past performance is indicative of future performance.' (SEC 2003)
Canada	'Forward-looking orientation' of information, by explaining 'management's strategy for generating value for investors over time.' (IASB 2007)
Australia	'provide them with a basis for forming a view as to likely future performance in the context of strategies for achieving long-term value creation and known trends in performance.' 'include an analysis of industry-wide and company-specific non-financial information...relevant to an assessment of the company's performance and prospects.' (G100 2003)
Singapore	none
Malaysia	none

Overview of disclosure

The disclosure of business forecast information in annual reports depends very much more on the jurisdiction within which the company operates its business than is the case for risk disclosure.

In addition to forward-looking statements throughout the annual report, some annual reports actually contain a designated section for such statements and for disclosure of business forecast information. This is particularly common among European companies' annual reports, but many other companies' annual reports also contain such a section.

Most of the annual reports prepared by the companies in the sample contain some kind of forecasting section; the only companies that fail to disclose this information tend to be based in Australia, Malaysia or Singapore (one company from each) or, more surprisingly, the US (two companies).

Although most companies disclose some kind of forward-looking information, some of them, usually in the Far East, tend to disclose this information within the chairman's statement or chief executive's statement, rather than within the main body of the annual report, as is done in the business review for UK-based companies. An example of this type of disclosure of business forecast information is found within the annual report for Petronas Gas Berhad, the Malaysia-based gas producer.

Looking ahead, we can expect challenging times in the year to come as our earnings have always remained heavily correlated with power and industrial growth. Against this backdrop, the Group must position itself favourably to ride this storm of uncertainties. Prudence in expenditure and cost containment measures have always been an integral part of our business operations.
(Petronas Gas Bhd 2009)

When this information is disclosed within the chairman's statement, little detail is provided about segment-specific business forecast information, although the disclosure does include some verifiable third-party information.

The best business forecast disclosures in terms of detail, length and clarity are those found within the annual reports of Western companies; sometimes the information is disclosed within one section, and sometimes within several separate sections, one for each of the business segments. This is fairly independent of the industrial sector in which the company operates.

The tendency for German companies' annual reports to feature more in-depth business forecast information is an important factor; always within their own section, these business forecast disclosures tend to relate the company's business forecasts to forecasts for the world economy in general, making extensive use of verifiable third-party information. Disclosures within the annual reports of UK-based companies are similar, usually featuring a separate section on business forecasting. Most of the similarities found between these two countries arise because both must follow the same EU legal requirements.

The annual report prepared by BG Group contains a one page 'Outlook' section that discloses most of the business forecast information to be found in the annual report. This information is somewhat more detailed than would be found in the chairman's statement. Even so, little information is given for different business segments, or indeed there is no gradation of information from the more general to the more specific. The use of a 'general to specific' approach, including extensive detail of the group's future prospects at each level, is particularly noticeable in the annual report for E.ON. The 'Forecast' section of the annual report (E.ON 2009) initially analyses the possible future 'Macroeconomic Situation', moves on to the company's expected future evolution within the 'Energy Industry', and is then followed by forward-looking information concerning the company's 'Efficiency-Enhancement Program', 'Employees' and 'Earnings'. The evolution from general to specific is most obvious within this Germany-based company's annual report, with the result that it contains one of the sample's most complete disclosures of business-forecast information.

Overall, disclosure of business forecasts across the sample of annual reports varies to some extent, depending mainly on the jurisdiction within which the company operates. Nonetheless, business-forecast information is disclosed within almost every annual report, although in varying degrees of detail. The extensive disclosures of business forecasts for European companies and some American companies are so detailed that almost every aspect of the company's business future, within each segment, is analysed in a forward-looking fashion, providing almost as much information as any user could desire. On the other hand, this may result in bloated annual reports that may be of more use as a doorstop, particularly for inexperienced users, who may be quite content with a short couple of paragraphs in the chairman's statement.

3. Future outlook

The future of narrative disclosure of risks and business forecasts within annual reports is somewhat unclear. Much research has found that, in practice, the narrative sections of annual reports do not disclose enough useful information to enable them to play a significant part in the investment decisions of analysts. Nonetheless, more work on the quality and content of these narratives may improve their usefulness to all users, regardless of experience.

One of the main hesitations over the future disclosure of risk and business forecast information is that excessive regulation results in more complex disclosures, and disclosure 'for the sake of it', instead of disclosures of real use to readers. On the other hand, a lack of regulation results in a lack of comparability between disclosures of companies based in different jurisdictions, which undermines the importance of the annual report narratives in affecting the users' decisions.

The balance of appropriate regulation is different depending on the information disclosed; business forecast information is disclosed more uniformly across annual reports than risk information, even though there is more regulation on risk disclosure. This is less valid for financial risk information, which is much more intrinsically linked to audited financial statements, and is therefore sometimes audited itself.

With respect to risk reporting, however, particularly financial risk reporting, IFRS is on its way. In 2005, all European Union countries, South Africa, Australia and Singapore adopted IFRS and its implementation is further planned for the Americas within the next few years, and other regions of the world thereafter. This standardisation of disclosure of financial risk information will contribute to the comparability of annual reports by users, regardless of experience. Disclosure of non-financial risk information is not, however, standardised by IFRS, and nor is disclosure of business forecast information.

The future standardisation of disclosures of risk and business forecast information within the narrative sections of annual reports for companies across the world is in discussion; the *Management Commentary Exposure Draft* and *Discussion Paper* (IASB 2009) prepared by the IASB address the 'management commentary' sections of the annual report, in other words, the narrative sections accompanying the company's financial statements. The

two documents represent two stages in the production of an international standard for narrative reporting, and include clauses on disclosures of qualitative risk and business forecast information.

The IASB *Management Commentary Exposure Draft* explains how good narrative reporting is helpful to users; that a:

Management commentary that includes a clear description of the most important resources, risks and relationships that management believes affect the entity's long-term value and how those resources, risks and relationships are managed provides useful information for users of the financial reports. (IASB 2009)

It also explains that the:

Disclosure of an entity's principal risk exposures, its plans and strategies for bearing or mitigating those risks, and the effectiveness of its risk management strategies, helps users to evaluate the entity's risks as well as its expected outcomes. (IASB 2009)

The exposure draft can be seen to incorporate some of the recommendations from previous annual report surveys, by emphasising that 'It is important that management distinguish the principal risks and uncertainties facing the entity, rather than listing all possible risks and uncertainties'.

Direct guidance about good management commentary is also detailed in the *Exposure Draft*, providing principles that can be followed on a global scale; for example:

'Management should disclose its principal strategic, commercial, operational and financial risks, being those that may significantly affect the entity's strategies and development of the entity's value'.

Few companies, on an international scale, disclose all types of risk implied above in the narrative of their annual reports, so there is hope that this may be the standardisation that we are looking for. This kind of guidance or requirement would ensure more comparability, at least, between different companies' risk profiles, regardless of the jurisdiction (IASB 2009).

Concerning business forecast and forward-looking information, the *Exposure Draft on Management Commentary* explains that:

Management commentary should include a clear description of the entity's financial and non-financial performance, the extent to which that performance may be indicative of future performance and management's assessment of the entity's prospects. (IASB 2009)

Appropriate disclosure in this area enables users to assess assumptions and judgements implied within financial statements, as well as providing important clues as to the future prospects of the company.

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