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Purpose of this paper

1. The purpose of this paper is to discuss what guidance should be included in the revised IFRS Practice Statement 1 *Management Commentary* (Practice Statement) on risks that an entity faces. In particular, this paper discusses:
 - (a) the disclosure objective for risks; and
 - (b) possible guidance supporting that disclosure objective, including on identifying the entity's key risks that would need to be addressed in management commentary.
2. This paper asks the Board for decisions on the disclosure objective for risks and on describing the key risks that would need to be addressed in management commentary.
3. The paper does not ask the Board for decisions on other aspects of the supporting guidance but invites comments from the Board. The staff will consider those comments and will either address them in drafting the forthcoming exposure draft or present further analysis to the Board at a future meeting.

Structure of this paper

4. This paper is structured as follows:
- (a) summary of staff recommendations (paragraph 5);
 - (b) summary of staff's research on risks (paragraphs 6–19);
 - (c) disclosure objective for risks, including:
 - (i) headline objective (paragraphs 24–30);
 - (ii) main assessments typically made by investors and creditors (paragraphs 31–35); and
 - (iii) types of information that need to be provided (paragraphs 36–42);
 - (d) possible guidance supporting the disclosure objective, including:
 - (i) how to identify key risks (paragraphs 44–53); and
 - (ii) what information to provide about key risks (paragraphs 54–58);
 - (e) Appendix A—Extracts from Practice Statement 1 *Management Commentary* on risks;
 - (f) Appendix B—Summary of feedback from the Management Commentary Consultative Group (MCCG) on risks; and
 - (g) Appendix C—Overview of other standard-setters' requirements and guidance on risks.

Summary of staff recommendations

5. The staff recommend that the revised Practice Statement:

- (a) specifies the disclosure objective for risks as follows:

Management commentary shall provide information and analysis to help investors and creditors understand the risks that could disrupt: the entity's business model; management's strategy for developing and sustaining that model; or the entity's resources and relationships.

That information and analysis helps investors and creditors assess:

- (i) the magnitude and likelihood of potential future disruption to the entity's ability to create value and generate cash flows; and
- (ii) how effectively management identifies and manages risks.

That information and analysis shall focus on the key risks and cover:

- (i) a description of the risks and of the entity's exposure to those risks; and
 - (ii) how management monitors and manages the risks, and would mitigate disruption if it occurs.
- (b) specifies that the key risks are those that could disrupt the entity's ability to create value and generate cash flows.

Summary of staff's research on risks

The existing Practice Statement

6. The existing Practice Statement states that investors and creditors need to understand the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies.¹ The Practice Statement discusses risks together with resources and relationships as factors which 'can affect the entity's value' and need to be managed. Paragraphs 31–32 of the Practice Statement provide guidance on risks and suggest that to help investors and creditors evaluate the entity's risks and expected outcomes, management should disclose:
- (a) the entity's principal risk exposures;
 - (b) changes in those risks;
 - (c) plans and strategies for bearing or mitigating those risks;
 - (d) the effectiveness of those strategies; and
 - (e) both exposures to negative consequences and potential opportunities.
7. The guidance states that management commentary should not list all possible risks and uncertainties, but should disclose the principal risks and uncertainties that may

¹ See paragraph 14 of the Practice Statement in Appendix A.

significantly affect the entity’s strategies and progress of the entity’s value. The guidance also states that:

- (a) the discussion of principal risks is necessary to understand management’s objectives and strategies for the entity;
- (b) risks can be:
 - (i) strategic, commercial, operational or financial in nature; and
 - (ii) external or internal to the entity.

8. The Practice Statement also specifically asks management to explain risks related to relationships and targets discussed in management commentary. The Practice Statement does not provide any further supporting guidance or illustrative examples. Appendix A includes extracts from the Practice Statement in relation to risks.

Investors and creditors’ information needs and gaps in reporting practice

9. As discussed in paragraph 5, in developing the existing Practice Statement the Board concluded that investors and creditors need to understand the entity’s exposure to risk, how risks are managed and whether management is effective in managing risks. The staff’s research and outreach confirm that information about risks is important to investors and creditors and that the existing Practice Statement correctly identifies the main areas of investors and creditors’ information needs in relation to risks, including the focus on principal (or key) risks. However, the staff’s findings suggest that those information needs are not always met in practice. In particular, some management commentaries:

- (a) provide a boilerplate discussion of risks;
- (b) do not focus on key risks that the entity faces, including over the long-term, or obscure the discussion of key risks by less important risks;
- (c) include insufficient detail about how management manages and mitigates risks;
- (d) do not explain how risks could affect the entity; and
- (e) provide a discussion that is not linked across areas of content.

10. The significance of information on risks was confirmed by PwC’s 2017 [Global investor survey on corporate reporting](#). The survey found that 84% of 554 investors thought that understanding management’s view of potential risks and their mitigation strategies is important for investors’ analysis and decision making. However, only 38% of investors had enough trust in the information companies report on strategic goals, risks and key performance indicators (KPIs), and only 37% believed that companies do a good job in linking strategic goals, risks, KPIs and financial statements.
11. In its 2017 project² on risks and 2018 implementation study³ on risks, the UK Financial Reporting Council (FRC)’s Financial Reporting Lab interviewed or surveyed over 200 investors and identified that investors were concerned by lack of detail in some areas of risk reporting. In particular, concerns were raised about the lack of detail on mitigating actions, about insufficient explanation of links between risks and the business model and KPIs, and about the lack of detail on emerging risks which were becoming an area of focus for investors, for example Brexit. The main findings on investors’ needs in these reports included:
- (a) disclosures on risks need to be given context by linking the discussion of risks to relevant areas in the annual report (ie in management commentary and the financial statements).
 - (b) different views on how many principal (or key) risks should be disclosed—some preferred a short list of five to ten principal risks, while others welcome a more comprehensive list.
 - (c) risks disclosed should be entity-specific, avoiding boilerplate disclosures, but macroeconomic, geopolitical or industry-wide risks should not be omitted, particularly the disclosure of how entities are responding to those risks.
 - (d) reasons for changes to assessments of principal risks should be provided, including when a risk is no longer considered to be a principal risk.

² Financial Reporting Lab, Project Report: [Risk and viability reporting](#), 2017

³ Financial Reporting Lab, Implementation Study: [Business model reporting](#); [Risk and viability reporting](#), 2018

- (e) information on likelihood and possible impact of principal risks is helpful, with many investors wanting narrative descriptions in addition to risk ‘heat maps’, and quantification of risks’ impact where possible.
 - (f) entities should be clear on prioritisation of risks by management. If not indicated, the prioritisation is assumed to be based on the order in which risks are presented.
 - (g) entities should be clear about whether they are disclosing information about principal risks on a gross basis or net of mitigating actions.
 - (h) information about the entity’s risk assessment process can help investors understand why management identified those risks as the entity’s principal risks, but must be entity-specific and avoid boilerplate.
12. In its [Long Term Reporting Guidance](#) issued in 2017, the Investment Association⁴ outlined its members’ expectations that entities should clearly disclose:
- (a) those key risks which could:
 - (i) significantly affect the successful delivery of their long-term strategy and ongoing operation of the business model; and
 - (ii) pose the greatest threat to the existence of the entity; and
 - (b) the actions being taken by management to mitigate the effect of those risks.
13. The Investment Association indicated that entities should disclose key risks, facing them over the next three to five years as a minimum, but over longer time horizons where possible. The Investment Association also recommended that entities should show how they are ‘creating, sustaining, and protecting value through the management of material environmental and social risks’.
14. The importance of disclosures on risks affecting the entity over the long term, particularly climate-related risks, was reiterated by the CEO of BlackRock⁵, in his 2020 annual letter

⁴ The Investment Association is the UK’s trade association for investment managers.

⁵ BlackRock is the world’s largest asset manager with c.\$7 trillion in assets under management (see its [Annual Report, 2019 pg 3](#)).

to CEOs. In the letter he stated that investors use risk disclosures to assess whether entities are properly managing and overseeing these risks within their business and adequately planning for the future. In the absence of robust disclosures, investors could conclude that the risks are not being adequately managed.

15. Suggestions that management commentary should discuss risks that could affect the entity over the long term, provide clarity on the time horizon over which risks are being assessed and reported and discuss risks arising from mega trends such as technological and climate change were also made by members of the Management Commentary Consultative Group (MCCG). Members also commented that the revised Practice Statement should include guidance on reporting risks that could disrupt the entity's access to its resources and relationships, in particular intangible ones. The staff discussed risks with the MCCG at their April and December 2019 meetings. Appendix B summarises the feedback from members of the MCCG and explains how the staff considered the feedback in developing recommendations for this paper.
16. The staff also discussed the disclosure objective for risks in management commentary with the Capital Markets Advisory Committee (CMAC). Comments from CMAC members included that:
 - (a) the guidance should emphasise that both long-term and short-term risks need to be discussed because entities could omit discussing some long-term risks if not explicitly required to do so; and
 - (b) entities should discuss both the likelihood of a negative outcome occurring and the magnitude of its effect if it does occur.

Overview of other standard-setters' guidance

17. In developing their recommendations on risks, the staff reviewed reporting frameworks issued by other standard-setters for requirements and guidance on risks. Appendix C includes details about how the staff conducted the review, and includes selected extracts from the frameworks that provide most detailed guidance on risks.

18. The national frameworks reviewed by the staff provide various amount of detail in guidance on describing risks in management commentary or equivalent document, and they also organise that guidance in various ways:
- (a) most require a description of ‘principal’, ‘major’ or ‘key’ risks, and discussion of the entity’s risk management strategy and mitigating actions;
 - (b) some list examples or types of risks to be disclosed;
 - (c) some state that the identification and management of risks is the responsibility of the entity’s board;
 - (d) some discuss risks together with the entity’s environment;
 - (e) some focus on financial risks; and
 - (f) a few provide explicit guidance on describing opportunities together with guidance on risks.
19. Where national frameworks list the types of risks they require or expect disclosures on, these include:
- (a) financial instruments risks (including disclosures on hedging);
 - (b) market risks such as price, credit, liquidity or cash flow risk;
 - (c) environmental, social and governance (ESG) risks (in those frameworks ‘ESG’ is used as a broad descriptor without specifying the types of risks);
 - (d) environmental risks, including climate change;
 - (e) health and safety risks; and
 - (f) bribery and corruption risks.

Disclosure objective for risks

20. As mentioned in paragraph 6, the existing Practice Statement states that management commentary should include ‘a clear description of the most important resources, risks and relationships that management believes can affect the entity’s value and how those resources, risks and relationships are managed’. This statement can be seen as a broad

objective for disclosure about risks, resources and relationships. However, it may not be sufficiently prominent or specific to help preparers identify information needed to meet this implied objective.

21. Accordingly, as explained in Agenda Paper 15 *Cover Paper*, the staff recommends that for each area of content the revised Practice Statement should set out:
 - (a) a headline objective (paragraphs 24–30);
 - (b) the main assessments typically made by investors and creditors (paragraphs 31–35); and
 - (c) types of information that needs to be provided (paragraphs 36–42).

22. Furthermore, as mentioned in paragraph 5, the existing Practice Statement discusses risks together with resources and relationships. However, as discussed in the April 2020 Agenda Paper 15D *Resources and relationships*, the staff think that the revised Practice Statement should provide guidance on resources and relationships separately from guidance on risks. This is because risks are different from resources and relationships in nature. Resources and relationships support the operation of the entity’s business model and implementation of management’s strategy. Risks can disrupt that business model and that strategy. Furthermore, risks can also affect the entity’s resources and relationships and can arise from those resources and relationships.

23. The Board tentatively approved the disclosure objective for resources and relationships in April 2020 (see Appendix A in Agenda Paper 15).

Headline objective

24. In developing the disclosure objective for risks, the staff considered what investors and creditors need to understand about risks to help them make their assessments of the entity’s prospects for future cash flows and of management’s stewardship of the entity’s economic resources.

25. As discussed in paragraph 7, the existing Practice Statement states that information about risks is useful if it helps investors and creditors understand ‘management’s objectives and strategies for the entity’. It also describes principal risks as ‘those that may significantly

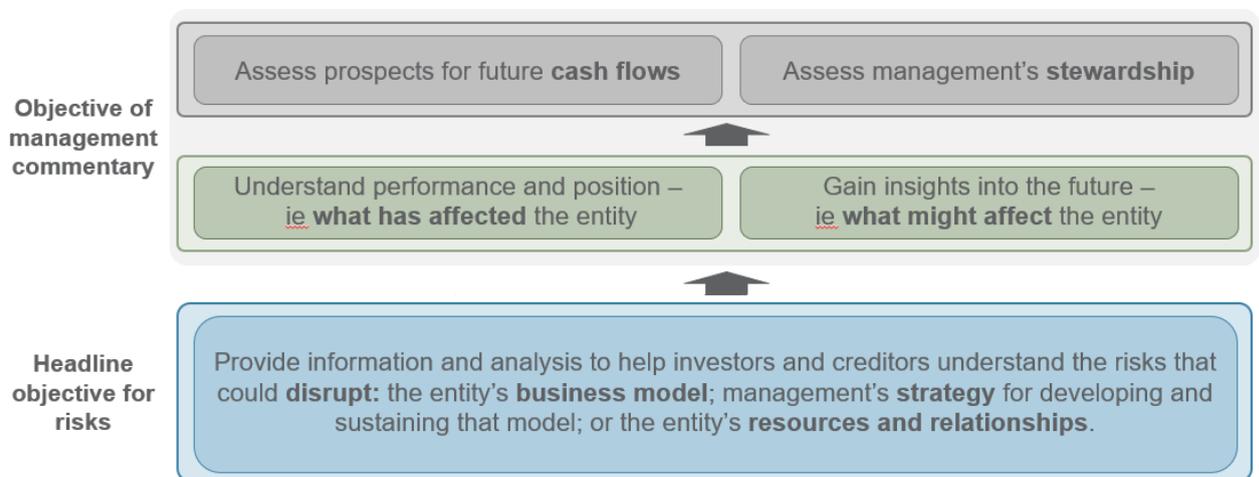
affect the entity's strategies and progress of the entity's value'. That description provides a link between risks and management's strategy and the entity's ability to create value.

26. As discussed in paragraphs 10–12, the staff's research indicates that investors and creditors need to understand risks that could affect the implementation of the entity's strategy or operation of the entity's business model, and so could affect the entity's performance and prospects for cash flows. As noted in paragraph 15, feedback from the MCCG indicated that investors are interested in risks that could disrupt the entity's resources or relationships, including intangible resources and relationships. Therefore, the staff think that the disclosure objective for risks should refer to risks that could affect:
- (a) the entity's business model;
 - (b) management's strategy for developing and sustaining that model; or
 - (c) the resources and relationships on which the business model and strategy depend.
27. Research also indicated that investors and creditors need material information about risks. In particular, they are interested in those risks that could reasonably be expected to significantly affect or threaten future operation of the entity's business model (see paragraph 12). Therefore, the staff think it would be helpful to indicate in the headline disclosure objective that investors and creditors need information about risks that could potentially have a significant negative effect. To convey that, the staff think that the headline disclosure objective should refer to risks that could *disrupt* the entity's business model, or management's strategy for developing and sustaining that model, or the entity's resources and relationships.
28. Risks primarily relate to what could affect the entity in the future, including over the long term, so information on risks is mainly intended to provide insights into the entity's future. In addition, some information about risks, for example, information about a previously reported risk for which an outcome occurred during the reporting period, could help investors and creditors understand what has affected the entity during the period. Therefore, information and analysis on an entity's risks can enhance investors and creditors' understanding of the entity's performance and position depicted in the related

financial statements and provide insights into factors that could affect the entity’s prospects, including over the long-term. Such information, together with information about management’s response to risks would help investors and creditors assess the entity’s prospects for future cash flows and assess management’s stewardship of the entity’s economic resources.

29. The relationship between the headline disclosure objective for risks and the overall objective of management commentary is illustrated in Figure 1.

Figure 1



30. For the reasons explained in paragraphs 26–28, the staff recommend that the headline disclosure objective for risks should be to provide information and analysis to help investors and creditors understand the risks that could disrupt: the entity’s business model; management’s strategy for developing and sustaining that model; or the entity’s resources and relationships.

Main assessments typically made by investors and creditors

31. As explained in Agenda Paper 15, disclosure objectives for the areas of content include a description of the main assessments that investors and creditors typically make in relation to an area of content. The purpose of providing that description would be to support the headline objective and help preparers identify information that needs to be provided in management commentary.

32. The staff’s research indicates that in relation to risks investors and creditors are looking to assess:
- (a) the magnitude and likelihood of potential future disruption to the entity’s ability to create value and generate cash flows (paragraph 33); and
 - (b) how effectively management identifies and manages risks (paragraphs 34–35).
33. As mentioned in paragraph 6, the existing Practice Statement notes that disclosures about risks help investors and creditors evaluate those risks and their expected outcomes. The importance of this assessment has also been confirmed by the staff’s research and outreach (see paragraphs 11 and 14). It showed that investors and creditors need to understand both the impact of negative outcomes (the magnitude of their effect if they occur) and the likelihood of those negative outcomes occurring, and also want to understand how risks affect the entity’s business model, strategy and resources and relationships, and consequently how they affect the entity’s ability to create value and generate cash flows.
34. The Practice Statement also asks for disclosure of the effectiveness of management’s risk management strategies.⁶ The staff think that information about management’s own assessment of its effectiveness may not be particularly useful. Instead, the staff think management commentary should provide information to help investors and creditors make their own assessment of management’s effectiveness in managing risks. This is highlighted, for example, in the CEO of BlackRock letter discussed in paragraph 14, which explains that investors use disclosures about risk to assess whether entities are properly managing and overseeing risks.
35. In addition to referring to ‘managing’ risks, the staff think that it would also be helpful to refer to ‘identification’ of risks in describing the assessments typically made by investors and creditors. This is because to be able to manage risks effectively, management must first correctly identify key risks that the entity faces.

⁶ See paragraph 31 of the Practice Statement in Appendix A.

Link to other areas of content

To make the assessments of risks discussed in paragraph 32, investors and creditors will use not only the information and analysis provided as part of the content on risks, but also information and analysis in other areas of content. In particular, investors and creditors could infer the *existence* of risks from information about the entity's business model, management's strategy, the entity's resources and relationships or the external environment. That information, combined with information about how risks are managed, would help investors understand how effectively management identifies key risks.

Types of information that need to be provided

36. The staff further considered what broad types of information and analysis need to be provided in management commentary to help investors and creditors make the assessments described in the previous section and to support the headline objective for risks as well as the overall objective of management commentary. On the basis of the guidance in the existing Practice Statement and of research into investors and creditors' information needs, the staff think that management commentary should focus on key risks and cover:
- (a) a description of the risks and of the entity's exposure to those risks (see paragraphs 37–38); and
 - (b) how management monitors and manages risks, and would mitigate disruption if it occurs (see paragraph 39).
37. The existing Practice Statement already requires information about an entity's principal risk exposures.⁷ The staff's research on investors and creditors' information needs confirms:
- (a) the importance of providing management's view of potential risks for investors' analysis of risks and their implications (see paragraph 10); and
 - (b) the need for management commentary to include information about the likelihood of a negative outcome occurring and the magnitude of its effect if it occurs (see paragraphs 11 and 16).

⁷ See paragraph 36 in Appendix A.

38. The staff think that preparers should be required to provide a description of the risks and of the entity’s exposure to those risks. The staff have used the term ‘exposure’ to capture both likelihood of an outcome occurring and the magnitude of its effect if it does occur. Supporting guidance on what information to provide as part of the description of the risks and of the entity’s exposure to those risks is discussed in paragraphs 54–56.
39. In addition, as highlighted in paragraphs 8 and 11, investors need to know whether management takes appropriate actions to manage risks and to mitigate disruption if it occurs. Insufficient information about management’s mitigating actions and plans has been identified as one of the gaps in the reporting practice (see paragraphs 9 and 11). Accordingly, the staff recommend that preparers should provide information related to how management monitors and manages the risks, and would mitigate disruption if it occurs. Supporting guidance on what information to provide on monitoring and managing risks, including mitigating potential disruption, is discussed in paragraphs 57–58.
40. As stated in paragraph 9, one of the main existing gaps in reporting practice identified by the staff is that entities’ descriptions of risks sometimes lack focus, resulting in key risks being obscured by less important risks. Therefore, the staff think that it would be helpful to require as part of the disclosure objective that information and analysis on risks should focus on the key risks.
41. The existing Practice Statement refers to ‘principal’, ‘most important’ and ‘most significant’ risks. However, the Practice Statement does not include guidance on how to identify those principal risks nor does it explain what information about them to provide. The staff considered what guidance could be provided to help preparers identify key risks in paragraphs 44–53.
42. To conclude, the staff recommend that the revised Practice Statement should require that the information and analysis on risks in management commentary focus on key risks and cover the following types of information:
- (a) a description of the risks and of the entity’s exposure to those risks;
 - (b) how management monitors and manages the risks, and would mitigate disruption if it occurs.

Question 1 for the Board

The staff recommend that the revised Practice Statement specifies the disclosure objective for risks as follows:

- (a) management commentary should provide information and analysis to help investors and creditors understand the risks that could disrupt: the entity's business model; management's strategy for developing and sustaining that model; or the entity's resources and relationships.
- (a) that information and analysis helps investors and creditors assess:
 - (i) the magnitude and likelihood of potential future disruption to the entity's ability to create value and generate cash flows; and
 - (ii) how effectively management identifies and manages risks.
- (b) that information and analysis should focus on the key risks and cover:
 - (i) a description of the risks and of the entity's exposure to those risks; and
 - (ii) how management monitors and manages the risks, and would mitigate disruption if it occurs.

Do you agree with these recommendations?

Possible guidance supporting the disclosure objective

43. To help preparers apply the disclosure objective for risks recommended above, the staff considered what supporting guidance could be included in the revised Practice Statement on:

- (a) identifying key risks (paragraphs 44–53); and
- (b) each broad type of information identified in the disclosure objective:
 - (i) a description of the risks and of the entity's exposure to those risks (paragraphs 54–56); and
 - (ii) how management monitors and manages the risks, and would mitigate disruption if it occurs (paragraphs 57–58).

How to identify key risks?

44. In July 2019, the Board tentatively approved guidance on making materiality judgements in preparing management commentary. Generally, information is considered material if it can reasonably be expected to affect investors and creditors’ assessment of the prospects for future cash flows and of management’s stewardship of the entity’s economic resources.

45. That guidance applies to all information in management commentary. To help preparers apply that guidance in identifying material information about risks, the staff suggest providing guidance on identifying ‘key’ risks, information about which is likely to be material to investors and creditors’ assessments.

46. In discussing key features of an entity’s business model, key aspects of management’s strategy for sustaining and developing that model and an entity’s key resources and relationships, the Board concluded that key items are those that relate to the entity’s ability to create value and generate cash flows. This definition is consistent with investors’ and creditors’ focus on the entity’s prospects for future cash flows, including over the long term. The staff think that the same principle applies to risk and recommend that the revised Practice Statement defines key risks as those that could disrupt the entity’s ability to create value and generate cash flows.

47. Furthermore, the staff think that the revised Practice Statement could also provide guidance to help preparers identify those key risks. As discussed in paragraph 26, investors and creditors focus on how risks affect the entity’s business model, management’s strategy for sustaining and developing that model and the entity’s resources and relationships. Accordingly, the staff think that possible examples of key risks are those that could disrupt:
 - (a) a key feature of the entity’s business model, such as risks that could result in a loss of the entity’s competitive advantage;
 - (b) a key aspect of management’s strategy, such as risks that could preclude achievement of important milestones; or
 - (c) a key resource or relationship, such as risks related to the entity’s reputation.

48. In addition, as discussed in paragraph 12, investors and creditors need information about the risks that threaten the entity’s existence. Therefore, another example of a key risk is an existential risk that could either make the entity no longer viable because of solvency or liquidity problems, or make the business model no longer viable because for example, its core product becomes illegal due to change in regulation.
49. The staff also considered whether some aspects of guidance on materiality discussed in July 2019 need to be further explained or highlighted in the guidance on identifying key risks. Specifically, in July 2019 the Board tentatively decided that the guidance on materiality would prompt management to consider the likelihood of a matter occurring, not just the magnitude of its effect, in making materiality judgements. In the July 2019 Agenda Paper 15B *Making relevance and materiality judgements*, the staff suggested that the revised Practice Statement should explain that:
- (a) normally, information about a matter is more likely to be considered material if both the likelihood of a matter occurring and the potential magnitude of its effect are high; but
 - (b) in some cases, management may need to provide information about a matter even if the likelihood of that matter occurring is low, for example, when the potential effect is very high.
50. The staff think that the latter point (ie the point in (b)) is particularly important for identifying key risks that need to be discussed in management commentary because a risk that could lead to a significant disruption may need to be discussed in management commentary even if the likelihood of that disruption is low if management considers that information about the risk could reasonably be expected to affect investors’ and creditors’ assessment of the entity’s prospects for future cash flows and of management’s stewardship of the entity’s resources.
51. As mentioned in paragraphs 13, 14 and 16, the staff’s research indicated that information about risks that entities face in the long term is important for investors and creditors. In the staff’s view it may be helpful to specify in the revised Practice Statement that a risk that could lead to a significant disruption may need to be discussed in management

commentary even if the potential disruption could only happen in the long term. In this case, management would need to consider the timing of the outcome and the effect of the time value of money in considering whether information about the risk could reasonably be expected to affect investors’ and creditors’ assessments of the entity’s prospects for future cash flows and of management’s stewardship.

52. Some jurisdictions may require entities to provide comprehensive lists of risks or risk factors that can affect the entity, and therefore some of these risks might not be considered to be key risks applying the guidance based on paragraph 46–48. As discussed in Appendix B to July 2019 Agenda Paper 15B, the staff plan to include in the revised Practice Statement a statement similar to paragraph 28 of the Practice Statement 2 *Making materiality judgements*—that providing information to meet local or regulatory requirements is not prohibited, if such information does not obscure information that is material in the context of the management commentary as a whole. The staff will consider whether to highlight in the guidance on risks that key risks need to be prominent and distinguishable from other risks which are included only for legal or regulatory purpose.

53. Finally, in the July 2019 discussion on materiality, the Board tentatively decided that the revised Practice Statement would refer to practical sources that could help management identify matters that may need to be discussed in management commentary. One of those practical sources was the entity’s capital market communications. The staff think that if interactions with investors and creditors make management aware that they expect a risk to affect the entity significantly, perhaps because it affects its industry peers, or if there is uncertainty about the effectiveness of management’s mitigating actions, management should consider referring to that risk in management commentary even if management concluded that the risk is not a key risk to the entity. In this case, management commentary could explain the reasons why management does not consider this to be a key risk to the entity.

Note on next steps – more than one business model

- Some risks might affect the entity as a whole and some others may affect a particular business model within a large company, or they might affect

different business models in different ways. Accordingly, some information about risks would need to be provided at the entity level and some would need to be provided at the business model level if an entity has several business models. The staff plan to address in a future paper how to provide information about several business models, including how reporting several business models interacts with segment reporting applying IFRS Standards.

Question 2 for the Board

The staff recommend that the revised Practice Statement specifies that the key risks are those that could disrupt the entity's ability to create value and generate cash flows.

Do you agree with this recommendation?

What information to provide about risks?

Description of the risks and of the entity's exposure to those risks

54. To understand the key risks that the entity faces investors and creditors need information on *what* risks can affect the entity and *how* they can affect the entity.
55. Possible guidance on describing what the key risks are could explain that management commentary may need to include information on:
 - (a) nature of risk—a description of the risk indicating what disruption the risk could result in, for example risk of disruption to supply chain or reputational risk. The description of risks should be specific to the entity and be based on the entity's internal classification. The Practice Statement may indicate that the guidance on key risks and examples of key risks provided in that guidance could help entities identify those risks but will not specify types of risks to be described in management commentary.

- (b) potential causes of risk—a description of factors, events or circumstances that could lead to the negative outcome occurring. Some causes are internal, such as problems in the operation of the business model or in the selection or execution of strategy, which would typically be within management’s control. Some causes may be partially or wholly external, such as those related to availability of scarce resources or discontinuation of a relationship or those related to trends and factors in the external environment. It may also be helpful to indicate in management commentary whether disruption can be caused by:
- (i) a one-off or rare but large-scale event, such as a natural disaster or a large-scale cyber attack;
 - (ii) a persistent or ongoing trend that would usually relate to continuing circumstances rather than single events, for example rising temperatures. However, some trends could emerge following an event, for example changes to travel patterns due to a pandemic; or
 - (iii) a combination of events or circumstances—a series of unrelated events or a set of circumstances which cumulatively lead to a concentration of risk and negative outcomes, even if individually such events or circumstances may not be considered significant. For example, liquidity risk could increase as a result of a combination of delays or default of payment by customers, changes to credit terms by suppliers and changes to tax laws resulting in obligations to make large tax payments.

56. Possible guidance on describing how the key risks could affect the entity could explain that management commentary may need to include information to help investors and creditors understand:

- (a) magnitude of the effect if the negative outcome occurs—quantitative or qualitative information might need to indicate the scale of potential disruption as a result of the negative outcome. This information could include an estimate of the range of possible outcomes or an estimate of the worst possible outcome. Management may also consider including scenario analysis if management has prepared such analysis and management considers that it could help investors and creditors in their assessments. In some cases, it may be difficult to quantify

the potential disruption in which case management may need to provide qualitative information to help investors and creditors make their assessments.

Link to other areas of content – business model, strategy, resources and relationships and performance, position and progress

- The discussion of the potential outcome needs to be linked to the information disclosed on specific features of the business model, or aspects of management’s strategy, or particular resources and relationships which would be disrupted by the risk and needs to provide an indication of the size or scale of the affected item. For example, management commentary could indicate that a risk of a loss of competitive advantage caused by a cheaper alternative offered by a new entrant in a particular geographical market could result in a 20 percent loss of revenue in that market which currently provides 15 percent of the entity’s total revenue.
- (b) likelihood of a negative outcome occurring—management commentary does not necessarily need to quantify the likelihood of a negative outcome occurring because it may not always be possible to make reasonable estimates of likelihoods. However, management commentary should include information to help investors and creditors estimate the likelihood of a negative outcome occurring because it would affect their assessments of the uncertainty of the entity’s future cash flows. Such information could include:
- (i) information on past trends or statistics about the occurrence of an event, for example a one in 50-years event;
 - (ii) whether the entity has any influence over whether the negative outcome occurs, and therefore whether it can take action to minimise its likelihood (see paragraph 58). Entities are typically less able to influence external causes of risk than internal causes of risk; or

- (iii) whether there are mitigating or exacerbating factors which decrease or increase the likelihood of the negative outcomes, such as government action or pressure by lobby groups.
- (c) timing of potential disruption—management commentary could indicate whether the risk is expected to affect the entity in the short, medium or long term.
- (d) change in the exposure—management commentary needs to highlight whether the risk is new, or if it has been discussed in previous reporting periods: whether there have been changes to the likelihood of a negative outcome occurring, the magnitude of its potential effect, or its timing. In addition, management commentary could explain why a risk which was described in the previous reporting period is no longer considered to be a key risk.

How management monitors and manages the risks, and would mitigate disruption if it occurs

57. As explained in paragraph 32, one of the assessments investors and creditors make in relation to risks is how effectively management identifies and manages risks. The staff do not expect management commentary to include detailed information on how management identifies key risks. As discussed in the note on link to other areas of content on page 13, investors and creditors can infer the existence of risks from information provided in other areas of content of management commentary and assess how effectively management identifies risks using information about risks disclosed in management commentary. In particular, information about how management monitors and responds to trends and factors in the external environment, as discussed in Agenda Paper 15B, could be helpful for this assessment. However, in some cases management may choose to describe particular aspects of the entity’s internal processes for identifying risks if it concludes that such information could help investors and creditors in their assessment.
58. The staff think that information about the other aspects of managing key risks, that is about monitoring the risks, minimising likelihood of a negative outcome occurring and mitigating disruption needs to be provided in management commentary. Possible guidance

in the revised Practice Statement could explain that management commentary may need to include information on:

- (a) monitoring the risk—a description of how management monitors factors that affect the risk, including the likelihood of a negative outcome occurring, the potential magnitude of its effect, and the timing of potential disruption. The description could include:
 - (i) what indicators management uses to monitor the risk (for example, external statistics or internal metrics used to measure exposure) and what controls are in place to identify significant changes in the timing or likelihood of the negative outcome and to determine whether management needs to take mitigating action.
 - (ii) a description of aspects of internal processes for monitoring the risk—management may consider specifying who is responsible for monitoring the risk, for example whether a specific committee has been established to monitor cyber risk or whether the CEO has taken responsibility for overseeing a risk. This could provide investors and creditors with useful information about management’s view of how significant the risk is to the entity (which could also provide an indication of the magnitude of its potential effect). Management may also consider providing information about the period of time being monitored and about how it determines the rank of the risk in its priorities.
 - (iii) how management monitors and measures the success of management’s risk management actions—management could use KPIs to monitor and measure the causes of the risk. For example, the number of health and safety accidents could be one measure of management’s success in managing one cause of reputational risk. Other KPIs could relate to what would be affected by the risk, such as measures of financial performance or employee satisfaction where positive trends could indicate that the related risk is being managed well.
- (b) minimising the likelihood of a negative outcome occurring—a description of the actions management is taking to reduce the chance of the negative outcome

occurring or to avoid concentration of risks through, for example, investment in new technology or reducing reliance on particular suppliers.

- (c) mitigating the magnitude of disruption if it occurs—a description of the preparatory actions management has already taken or the actions it plans to take to mitigate the disruption if it occurs. Examples of actions that management has already taken could include entering into hedging arrangements to mitigate currency risks or developing business continuity plans for incidents such as fire, explosion or natural disasters affecting a factory. Examples of actions that management plans to take to mitigate disruption if it occurs could include switching to alternative suppliers with whom a relationship is already established or switching to remote working if offices become inaccessible.

Question 3 for the Board

Paragraphs 54–58 provide staff’s discussion of the possible guidance supporting the disclosure objective for risks that could be included in the revised Practice Statement. Do you have any questions or comments on that discussion?

Appendix A—Extracts from Practice Statement 1 *Management Commentary on risks*

IN3 [...] Users routinely use the type of information provided in management commentary to help them evaluate an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives. [...]

Principles

[...]

14 Management commentary should provide information to help users of the financial reports to assess the performance of the entity and the actions of its management relative to stated strategies and plans for progress. That type of commentary will help users of the financial reports to understand, for example:

(a) the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;

[...]

Elements of management commentary

24 Although the particular focus of management commentary will depend on the facts and circumstances of the entity, management commentary should include information that is essential to an understanding of:

- a) the nature of the business;
- b) management's objectives and its strategies for meeting those objectives;
- c) the entity's most significant resources, risks and relationships;
- d) the results of operations and prospects; and
- e) the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

[...]

Resources, risks and relationships

29 Management commentary should include a clear description of the most important resources, risks and relationships that management believes can affect the entity's value and how those resources, risks and relationships are managed.

Risks

31 Management should disclose an entity's principal risk exposures and changes in those risks, together with its plans and strategies for bearing or mitigating those risks, as well as disclosure of the effectiveness of its risk management strategies. This disclosure helps users to evaluate the entity's risks as well as its expected outcomes. Management should distinguish the principal risks and uncertainties facing the entity, rather than listing all possible risks and uncertainties.

32 Management should disclose its principal strategic, commercial, operational and financial risks, which are those that may significantly affect the entity's strategies and progress of the entity's value. The description of the principal risks facing the entity should cover both exposures to negative consequences and potential opportunities. Management commentary provides useful information when it discusses the principal risks and uncertainties necessary to

understand management's objectives and strategies for the entity. The principal risks and uncertainties can constitute either a significant external or internal risk to the entity.

Relationships

33 Management should identify the significant relationships that the entity has with stakeholders, how those relationships are likely to affect the performance and value of the entity, and how those relationships are managed. This type of disclosure helps users of the financial reports to understand how an entity's relationships influence the nature of its business and whether an entity's relationships expose the business to substantial risk.

Prospects

36 Management should provide an analysis of the prospects of the entity, which may include targets for financial and non-financial measures. [...] When targets are quantified, management should explain the risks and assumptions necessary for users to assess the likelihood of achieving those targets.

Appendix B—Summary of feedback from the Management Commentary Consultative Group (MCCG) on risks

In April 2019, the MCCG discussed the staff’s initial ideas for the possible guidance on risks (at that meeting guidance on the external environment and risks was provided together). The staff’s suggestions for risks included linking identification of risks to be described to their potential effect on the entity’s prospects for future cash flows (including likelihood and magnitude), identifying the possible sources of risks, and setting out types of information to be provided about risks in management commentary. In addition, in December 2019, the MCCG discussed the staff’s ideas for a disclosure objective for risks and whether risks should be reported before or after mitigating actions.

The following table summarises the feedback received from members of the MCCG on the staff’s proposed guidance and explains how the feedback has been considered in the staff’s revised proposals for guidance on risks.

Feedback	Staff’s response
Suggestion that management commentary should describe risks that could affect the entity over the long term.	The staff plan to emphasise in the draft Practice Statement that factors affecting an entity’s ability to create value and generate cash flows include factors affecting its ability to do so in the long term. So referring to risks that could disrupt the entity’s ability to ‘create value and generate cash flows’ will indicate that preparers should consider a longer time horizon in identifying risks that need to be described in management commentary.
Suggestion that management commentary should be clear on the time horizon over which risks are being assessed and reported.	Guidance supporting the disclosure objective on risks suggests that for key risks management commentary should describe the likelihood of a negative outcome occurring, the magnitude of its effect if it does occur and the timing of potential disruption. The staff also expect that investors and creditors will be able to understand the time horizon over which risks are being assessed based on the management’s description of how it monitors and manages risks (see paragraphs 57–58).

<p>Suggestion that management commentary should include a description of risks outside an entity’s control that could disrupt the entity’s access to its intangible resources and relationships.</p>	<p>The disclosure objective for risks explicitly refers to risks that could disrupt the entity’s resources and relationships (these include intangible resources and relationships).</p>
<p>Suggestion that management commentary should discuss risks arising from mega trends, such as major technological changes and climate change.</p>	<p>Suggested guidance on risks does not include a list of risks that should be described in management commentary. Instead, the staff suggests including in the revised Practice Statement guidance on identifying key risks for inclusion in management commentary. Based on the guidance in paragraph 46, risks arising from mega trends could be identified as key if they could disrupt the entity’s ability to create value and generate cash flows.</p>
<p>Suggestion that:</p> <ul style="list-style-type: none"> (a) the revised guidance should both opportunities and risks; and (b) management commentaries should include a balanced discussion of risks and opportunities. 	<p>The staff agree that information about opportunities is useful to investors and creditors. However, the staff think that the investors and creditors may need different information about opportunities than about risks. Accordingly, the staff suggest not combining guidance on opportunities and guidance on risks. Opportunities are addressed in guidance on external environment as discussed in Agenda Paper 15B for this meeting and in guidance on strategy as discussed at the April 2020 meeting.</p>
<p>Members generally agreed that management commentary should describe only key risks, that is risks information about which is likely to be material to investors and creditors’ assessments. However, members representing preparers expressed concerns that:</p> <ul style="list-style-type: none"> (a) focusing on only key risks may be difficult in practice because in their jurisdictions legal advice is to cover all possible risks in management commentary; and 	<p>Paragraph 52 explains that the staff is considering including in the revised Practice Statement a statement that providing information to meet local and regulatory requirement is not prohibited if such information does not obscure information that is material for the management commentary.</p>

<p>(b) selecting information, particularly on risks, based on an assessment of likelihood poses a litigation risk, which entities in their jurisdiction (ie North America) are generally unwilling to take.</p>	
<p>Request for more guidance on identification of risks, including on how likelihood and magnitude should be considered in identifying risks.</p>	<p>Paragraph 49 sets out possible guidance that could be included in the revised Practice Statement on considering likelihood and magnitude in identifying key risks.</p>
<p>Concern about using both magnitude and likelihood as a basis for identifying key risks because in some cases this may lead to disclosing sensitive information (for example, in litigation cases).</p>	<p>The staff will consider if any guidance on providing sensitive information is needed in the revised Practice Statement.</p>
<p>Suggestion that management commentary should explain the process of identifying key risks.</p>	<p>The staff think that a requirement for such disclosure could lead to preparers providing boilerplate information. However, as noted in paragraph 57, management can include such information in management commentary if it determines that it would be helpful to investors and creditors in understanding the entity’s risks and how management manages those risks.</p>
<p>Suggestion that the disclosure objective for risks should refer to risks that ‘could materially affect’ instead of ‘could affect’</p>	<p>As discussed in paragraph 27, the revised headline disclosure objective uses ‘could disrupt’ to capture significant negative consequences of risks. In addition, the staff proposes guidance on identifying key risks information about which is likely to be material to investors and creditors’ assessments.</p>
<p>In April 2019 members expressed mixed views on whether risks should be reported before mitigating actions (gross) or after mitigating actions (net).</p>	<p>Supporting guidance on risks includes guidance on describing risks (paragraphs 54–56) and on describing how management mitigates against those risks (paragraphs 57–58).</p>

<p>In December 2019, members agreed that risks in the management commentary should be reported gross of mitigating actions subject to management commentary covering only key risks information about which is material.</p>	
<p>Query whether proposed guidance required categorisation of risks in management commentary.</p>	<p>Any types or categories of risks discussed in the suggested guidance are intended to be used as prompts for identifying the risks, not as categories of risks to be reported in management commentary. In its commentary, management should describe risks based on how they are monitored and managed internally.</p>
<p>Mixed views on whether the discussion of risks should distinguish between risks that an entity can and cannot control.</p>	<p>Possible supporting guidance on risks does not ask preparers to distinguish whether the risks can be controlled. The staff think that investors and creditors will be able to make their own assessments of this based on information provided about how management monitors, manages and mitigates the risks.</p>

Appendix C— Overview of other standard-setters' requirements and guidance on risks

The staff reviewed reporting frameworks issued by other standard-setters to identify themes reflected in their requirements or guidance on external environment disclosures. The staff's review covered responses from 24 national standard-setters to the staff's request for information about requirements and commonly applied non-mandatory guidance in their jurisdictions.⁸ The staff also reviewed EU Non-financial Reporting Directive (2014/95/EU) and the related European Commission Guidelines on non-financial reporting, and the International Integrated Reporting Council <IR> Framework, because some jurisdictions require or encourage management to refer to these sources in preparing management commentary.

As part of the review, the staff identified that some frameworks refer to the recommendations on risk disclosures in the [Final Report: Recommendations of the Task Force on Climate related Financial Disclosures](#) (TCFD). As a result, the staff reviewed these recommendations. Although the risks discussed relate specifically to climate change, the approach to disclosures could potentially be applied to other risks. The staff noted that the TCFD recommendations identify two major categories of risks:

- (d) transition risks, which may include policy and legal, technology, reputational or market risks and arise from changes in the external environment in response to trends and factors; and
- (e) physical risks, which are event driven and can be either chronic or acute (one-time) and typically relate to the operation of the business model.

The TCFD recommendations also include guidance on risk disclosures covering:

- (a) risk management process to identify, assess and manage risks;
- (b) impacts on the entity's strategy and financial planning, by performing scenario analysis; and
- (c) metrics and targets to assess and manage risks and opportunities.

As discussed in paragraph 18, most requirements or guidance specifically refer to providing information on risks, but the level of detail varies. In the table below we include extracts of other standard-setters' requirements or guidance that provide more detailed guidance on risks, as identified in the staff's review.

⁸ See Appendix A of November 2018 Agenda Paper 15B *Summary of research into the objective of management commentary* for further details.

Extracts from guidance on risks

Australian Securities & Investments Commission Regulatory Guide 247 Operating and Financial Review (OFR) - 2019

RG 247.62 It is important that a discussion about future prospects is balanced. It is likely to be misleading to discuss prospects for future financial years without referring to the material business risks that could adversely affect the achievement of the financial prospects described for those years. By ‘material business risks’, we mean the most significant areas of uncertainty or exposure, at a whole-of-entity level, that could have an adverse impact on the achievement of the financial performance or outcomes disclosed in the OFR. [...]

RG 247.63 An OFR should:

- (a) only include a discussion of the risks that could affect the entity’s achievement of the *financial* prospects disclosed, taking into account the nature and business of the entity and its business strategy; and
- (b) not contain an exhaustive list of generic risks that might potentially affect a large number of entities.

RG 247.64 An OFR should include a discussion of environmental, social and governance risks where those risks could affect the entity’s achievement of its *financial* performance or outcomes disclosed, taking into account the nature and business of the entity and its business strategy.

RG 247.65 Each risk that is disclosed should:

- (a) be described in its context (e.g. why the risk is important or significant, and its potential impact on the entity’s financial prospects);
- (b) include any relevant associated analytical comments (e.g. whether the risk is expected to increase or decrease in the foreseeable future); and
- (c) where the risk relates to factors within the control of management, specify how these factors will be controlled or managed by the entity.

RG 247.66 Climate change is a systemic risk that could have a material impact on the future financial position, performance or prospects of entities. Examples of other risks that could have a material impact for particular entities may include digital disruption, new technologies, geopolitical risks and cyber security. Directors may also consider whether it would be worthwhile to disclose additional information that would be relevant under integrated reporting, sustainability reporting or the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), where that information is not already required for the OFR.

European Commission Guidelines on non-financial reporting (methodology for reporting non-financial information) (2017/C 215/01)

4.4 Principal risks and their management

Article 1 of the Directive states that the non-financial statement must contain information including: *‘the principal risks related to those matters linked to the undertaking’s operations including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the undertaking manages those risks;’*

Companies should disclose information on their principal risks and on how they are managed and mitigated. Those risks may relate to their operations, their products or services, their supply chain and

Extracts from guidance on risks

business relationships, or to other aspects. This would include an appropriate perspective on short, medium and long-term principal risks. Companies are expected to explain how principal risks may affect their business model, operations, financial performance and the impact of their activities.

A company is expected to disclose material information on principal risks, regardless of whether they stem from its own decisions or actions, or from external factors, and to explain the processes used to identify and assess such risks.

Disclosures, where relevant and proportionate, should include material information on supply and subcontracting chains. They should also include material information on how a company manages and mitigates principal risks.

A company is expected to highlight and explain any material changes to its principal risks, or to the way it manages them, in the reporting year.

German Accounting Standard (GAS) 20 – Group Management Report

135. Risk reporting encompasses disclosures on the risk management system, disclosures on individual risks and a summary presentation of the risk position.

146. Risks that could affect the decisions of a knowledgeable user shall be reported.

147. The subject and scope of reporting shall depend on the specific circumstances of the group and its entities as well as on their market and sector-specific environment. The information provided shall focus primarily on the risks associated with the specific circumstances of the group and its business activities. These may arise both from the entity’s environment (external risks) and from within the entity itself (internal risks).

148. A risk whose occurrence would probably threaten the continued existence of the group or of one of its material group entities shall be indicated as such.

149. The material risks shall be presented individually. The expected consequences of their occurrence shall be analysed and assessed.

150. The presentation of the risks shall reflect their importance for the group or for material entities included in the consolidated financial statements.

151. If the consolidated financial statements include segment reporting, the segments affected by the risks shall be disclosed in the presentation of the risks, to the extent that they are not self-evident.

152. The risks presented shall be quantified if this is also done for internal management purposes and the quantitative disclosures are material for a knowledgeable user. In this case, the values calculated internally shall be presented and the models used and their assumptions shall be presented and discussed.

153. For example, market risk can usually be quantified using sensitivity analyses and measures such as value at risk. The quantitative disclosures can be more heavily aggregated in the group management report than when they are used for internal management purposes.

Extracts from guidance on risks

154. Quantitative disclosures on risks can be omitted in special circumstances in which it is to be expected that the disclosure of information in accordance with para. 152 would materially adversely affect the position of the group (e.g. in a legal dispute). In this case, the reasons for omitting the disclosures shall be presented.

155. The assessment of the risks shall be performed as of the reporting date. If the importance of risks changes after the end of the reporting period, or if new risks emerge or existing risks no longer apply, the modified assessment of the risks shall additionally be presented if this is necessary to convey a suitable understanding of the group's risk position.

156. The assessment of the individual risks shall be based in each case on an appropriate period. This period shall correspond at a minimum to the forward-looking period used. The period for the assessment of whether there are risks to the continued existence of the group shall be at least one year, calculated from the reporting date of the consolidated financial statements.

157. The effects of risks shall be presented and assessed. In doing so, the risks can be presented and assessed before techniques used to mitigate risks, and the techniques used to mitigate risks can be presented and assessed (gross presentation). Alternatively, the risks remaining after the implementation of risk mitigation techniques can be presented and assessed (net presentation). In this case, the techniques used to mitigate risks shall be presented.

159. Significant changes in risks compared with the previous year shall be presented and discussed.

160. Following the presentation of the risks, a summary shall be provided setting out the overall risk position of the group. Diversification effects may be taken into account in this summary.

161. It may be appropriate in this context to address the group's risk-bearing capacity, for example.

162. To enhance the clarity and transparency of the risk report, the individual risks shall either be ranked by their importance or combined into categories of similar risks. The disclosures can also be made separately for specific segments.

163. Ranking the risks presents them in the order of their relative importance. This importance is determined on the basis of the probability of occurrence and their potential effect on achieving forecasts or the group's objectives. The material risks may be ranked overall or combined into classes ranked by their importance (e.g. A, B and C risks).

164. When combining similar risks to form categories, the parent entity may be guided by the internally defined risk classification used for risk management purposes. Alternatively, the following classification may be chosen: (1) external risks, (2) sector-specific risks, (3) performance risks, (4) financial risks and (5) other risks.

International Integrated Reporting Council <IR> Framework
Risks and opportunities

4.23 An integrated report should answer the question: What are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organization dealing with them?

4.24 An integrated report identifies the key risks and opportunities that are specific to the organization, including those that relate to the organization's effects on, and the continued

Extracts from guidance on risks

availability, quality and affordability of, relevant capitals in the short, medium and long term.

4.25 This can include identifying:

- The specific source of risks and opportunities, which can be internal, external or, commonly, a mix of the two. External sources include those stemming from the external environment. Internal sources include those stemming from the organization’s business activities.
- The organization’s assessment of the likelihood that the risk or opportunity will come to fruition and the magnitude of its effect if it does. This includes consideration of the specific circumstances that would cause the risk or opportunity to come to fruition. Such disclosure will invariably involve a degree of uncertainty.
- The specific steps being taken to mitigate or manage key risks or to create value from key opportunities, including the identification of the associated strategic objectives, strategies, policies, targets and KPIs.

4.26 Considering the Guiding Principle, Materiality, the organization’s approach to any real risks (whether they be in the short, medium or long term) that are fundamental to the ongoing ability of the organization to create value and that could have extreme consequences is ordinarily included in an integrated report, even when the probability of their occurrence might be considered quite small.

UK Financial Reporting Council – Guidance on the Strategic Report

7.27 The strategic report must include a description of the principal risks and uncertainties facing the entity and should include an explanation of how they are managed or mitigated.

7.28 The risks and uncertainties included in the strategic report should be limited to those considered by the entity’s management to be material to the development, performance, position or future prospects of the entity. They will generally be matters that the board regularly monitor and discuss because of their likelihood, the magnitude of their potential effect on the entity, or a combination of the two.

7.29 The board should consider the full range of business risks, including both those that are financial in nature and those that are non-financial. Principal risks should be disclosed and described irrespective of whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control.

7.30 Principal risks should include, but are not necessarily limited to, those risks that could result in events or circumstances that might threaten the entity’s business model, future performance, solvency or liquidity, or result in significant value erosion. In determining which risks are the principal risks, entities should consider the potential impact and probability of the related events or circumstances arising and the timescale over which they may occur.

7.31 Where the entity is facing long-term systemic risks which may have a material effect on the entity’s ability to generate and preserve value in the long term, the strategic report could explain the potential impact on the entity’s strategy and business model if those risks crystallise. {example on climate change is provided}

7B.32 The descriptions of the principal risks and uncertainties should be specific so that a shareholder can understand why they are material to the entity. This might include a description of the likelihood of the risk, an indication of the circumstances under which the risk might be most relevant to the entity and its possible effects. An explanation of

Extracts from guidance on risks

how the principal risks and uncertainties are managed or mitigated should also be included to enable shareholders to assess the impact on the future prospects of the entity.

Linkage example

Where relevant, the description of the principal risks and uncertainties facing the entity should include linkage to and discussion of the entity's strategy and/or business model. Any linkage to accounting estimates and judgements disclosed in the notes to the financial statements, the going concern statement, trends or factors from the external environment described elsewhere in the strategic report, or any other linked disclosure in the annual report, could also be highlighted and, where relevant, discussed. Emphasising the relationship between an entity's principal risks and its ability to meet its objectives may provide relevant information and provide insight into an entity's risk appetite.

7.33 Significant changes in principal risks such as a change in likelihood, probable timing or possible effect, or the inclusion of new risks, should be highlighted and explained.

Example

Where the risk profile of an entity has changed, many entities explain whether the individual risks identified have increased, decreased or remained the same severity. The risk mitigation could also show how the entity has responded to the change. For instance, in recent years, the cyber risk faced by many entities has significantly increased. The risk disclosures could explain the ways in which cyber risk could affect the business, for instance, a cyber attack, loss of sensitive data leading to a lack of customer confidence, a failure of IT systems leading to a failure to operate certain elements of the business etc. The risk mitigation could explain the processes that the entity has put in place to mitigate the increased risk.

7.34 The entity should look beyond its own operations and consider how risks and impacts arising from business relationships, products and services, affect its principal risks. For instance, entities could consider the reputational risk arising from factors such as poor labour practices in its supply chain or purchasing products which have been produced in a manner which has a significant environmental or ecological impact.