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Social and Environmental Determinants of Risk and Uncertainties Reporting*

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Abstract

Recently, risk reporting has gained interest in financial reporting practice, regulation, and international research. Social and environmental reporting is seen to benefit shareholders more by reducing risk than by increasing return. The researchers showed that the annual report is the most favoured channel of disclosure, along with presentation to investors. The general message is that, as far as annual reports go, quantified, verifiable disclosures have the most credibility and relevance. Our paper is meant to develop an analysis of specific requirements regarding risks and uncertainties reported into the financial statements according to different standards (US-GAAP, IFRS, and European Directives) and their connection to social and environmental information that an entity should disclose. We focus on fundamental research that is related to inductive accounting theory and uses scientific methods for identification of corporate reporting theoretical and practical difficulties in European and international economic entities.

Keywords: *Risks and uncertainties, Corporate risk disclosure, Social and environmental reporting Financial statements, Non-financial risks*

1. Literature review: Social and environmental information and risk reporting

In the knowledge society we are now living in, the importance of information on corporate aspects which are not shown in financial statements is steadily growing. Adequate steering indicators and internal reports for social and environmental aspects introduced by the management of an entity have stimu-

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lated external reports to present those to the broad public. Villiers and Staden (2006) conducted a content analysis of more than 140 corporate annual reports over a nine-year period in order to identify the trends in environmental disclosure. There is a consensus that the business reporting model needs to expand to serve the changing information needs of the market and provide the information required for enhanced corporate transparency and accountability (Lungu et al., 2008).

In our paper, data coming from accounting literature, accounting settlers' requirements and entities' experience are gathered, analyzed and interpreted in order to bring to light an underlying coherence and sense for the new risk reporting perspective. This kind of analysis will offer us the opportunities of deeply research the concepts, the policies and the social and environmental indicators, as risks and uncertainties generating factors. It is the stand-point in developing corporate reporting requirements, based on current reporting standards.

The main reporting instruments (as balance sheet, profit and loss account, notes etc.) contain reliable data as they report on the past. This orientation to the past reduces their forecasting power whereas actual and potential stakeholders need future-oriented data to be able to prepare their decisions. Future-oriented data, however, can be rarely determined unequivocally, and consequently are not regarded as reliable in principle. This conflict between relevance and reliability in accounting can never be solved due to the uncertainty of the future (Altenburgeret and Schaffhauser-Linzatti, 2007). Current tendencies, especially in the International Financial Reporting Standards, emphasize the increasing inclusion of present and future-oriented information, imposed by risks and uncertainties, in corporate reporting.

Corporate social and environmental reports today represent several decades of incremental change, but the incentives are still different in developed countries and in developing countries. While on the surface they appear improved (there are more factual data), the management processes used to craft these reports have changed very little. Some studies conducted in the context of developed countries (Albuquerque et al., 2007; O' Dwyer, 2002; Solomon and Lewis, 2002) argue that incentives should be encouraged to force companies to disclosure its information. However, only few papers have discussed this issue in the developing world context (Ite, 2004; Pedwell, 2004). According to Solomon and Lewis (2002), in the Britain context, companies consider the recognition of their social commitment as main cause for corporate environmental disclosure. However, in opinion of some users groups, the corporate responsibility is not considered main cause for reporting, they have the opinion that organizations disclose environmental information only to improve their image. Both in developed and developing countries, issuers consider their reason as much more altruistic than the opinion of the different users group.

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The lack of information on risks facing companies is one of the main weaknesses in the accounting information disclosed by firms. Current literature assumes corporate risk reporting to be informative for its users. Nowadays, companies are obliged to issue few items of this kind of information. Linsley and Shrives (2006) assert that current analyses of risk are dominated by Beck’s notion that a risk society now exists whereby we have become more concerned about our impact upon nature than the impact of nature upon us. Beck refers to these risks as manufactured uncertainties and observes that they can arise out of a desire to reduce risk.

Worldwide, regulators view narrative disclosures as the key to achieving the desired step-change in the quality of corporate reporting. Accounting researchers have increasingly focused their efforts on investigating disclosure and it is now recognised that there is an urgent need to develop disclosure metrics to facilitate research into voluntary disclosure and quality. This was the main theme in much of the early literature on social and environmental accounting (Bebbington and Thompson 1996; Gray et al., 2001) and has been largely responsible for prompting many companies to publish social and environmental reports (Lober et al., 1997). It is no longer a particularity of the banking and insurance sectors which currently reassess the role of risk reporting for market discipline (IAIS, 2002; Dardis, 2002; Helbok and Wagner, 2006; Crumpton et al., 2006).

Changing economic and regulatory environments, more complex business structures and risk management, increasing reliance on financial instruments and international transactions, and prominent corporate crises gave rise to risk reporting in non-financial sectors. In general terms, risk reporting shall allow outsiders to assess the risks of an entity's future economic performance (Schrand and Elliott, 1998; Linsley and Shrives, 2006).

In recent times, the demand for disclosure of most important listed companies has dramatically increased and the failures of large companies listed on the most important stock exchanges have placed extra pressure on them and standard setters for the increase in the quality of corporate reporting (Beretta and Bozzolan, 2004). In answer to this, we witnessed a significant administrative reform, in terms of the increasing number of major companies proclaiming their social responsibility, and backing up their claims by producing substantial environmental and social sustainability reports (Cooper and Owen, 2007). Stuart and Owen (2007) critically evaluate the degree of institutional reform, designed to empower stakeholders, and thereby enhance corporate accountability in UK quoted companies. Also, a study on The World Bank’s performance in developing countries argues that the conventional accounting framework is not an appropriate tool to guide organized effort in balancing the competing-interdependent needs of multiple stakeholders (Rahaman et al., 2004), in order to be aware of contingent social and environmental risks and uncertainties.

Another concern is that companies do not provide sufficient information about risk and risk management (ICAEW, 2002). The information as it currently stands is too brief, not sufficiently forward looking and not wholly adequate for decision-making purposes (Helliar et al., 2002; Beretta and Bozzolan, 2004; Cabedo and Tirado, 2004). Therefore, accounting bodies have been motivated to take greater interest in establishing risks to be reported and to require entities to collect and disseminate a greater body of risk information (Sarbanes-Oxley, 2002; ICAEW, 2002; Linsley and Shrives, 2006). Thomas (1986) explored the hypothesis that certain disclosure and measurement practices in corporate reporting are contingent upon environmental uncertainty, technology and organisation size. The findings showed that while the disclosure of forecast information is associated with environmental homogeneity, certain measurement practices are primarily influenced by company size.

Regulators and other industry associations have recognised the importance of considering the industry setting when determining environmental and social policy and reporting requirements. However, environmental and social impacts vary greatly from industry to industry. Guthrie et al. (2007) find that the sample companies reported more on industry-specific issues than general environmental and social issues. This finding also highlights the need for researchers examining environmental and social disclosures to consider incorporating industry-specific items into their disclosure instruments. The study also finds that the companies tended to use corporate websites for their environmental and social reporting, indicating the need for researchers to consider alternative media (Jackson and Quotes, 2002).

According to Abraham and Cox (2007), a significant extent of UK research has explored corporate disclosure (Cooke and Wallace, 1990; Meek et al., 1995; Ahmed and Courtis, 1999; O'Sullivan, 2000; Adams, 2002; Camfferman and Cooke, 2002; Stanton and Stanton, 2002; Watson et al., 2002). Beattie (2005) surveyed UK financial accounting research published over a 10-year period and found that 23% of the entire output comprised studies on corporate disclosure. One strand of this literature on corporate disclosure concerns information on risk. Existing explorations have tended to concentrate on specific aspects of risk disclosure, and in particular the disclosure of market based risk in relation to financial instruments (Beretta and Bozzolan, 2004; Linsley and Shrives, 2006).

Apart from the financial sectors, published research on risk reporting has to date been rather limited. Most efforts are empirical and the conclusions are so different. Parts of the literature consider risk reporting as largely beneficial for disclosing entities, assuming both lower cost of capital (ICAEW, 1999; Solomon et al., 2000) and disciplining effects on risk management and governance (Linsley and Shrives, 2000; Jorion, 2002). While this implies prevalent incentives to voluntarily report on risk, empirical research documents poor voluntary risk reporting on average (Beretta and Bozzolan, 2004; Mohobbot, 2005). Given this observation, parts of the literature also infer that (some) managers have limited incentives of disclose private risk information and recommend extending risk reporting requirements (Carlon et al., 2003; Lajili and Zeghal, 2005). However, empirical studies find large variations and deficits in risk reporting even in the presence of disclosure rules (Rajgopal, 1999; Kajüter and Esser, 2007). What emerges is in line with recent accounting research findings: Incentives matter even in the presence of regulation. This is particularly likely when considering risk reporting, because it is subjective and partly non-verifiable, which inherently allows for discretion. Yet, there is very little work on risk reporting incentives and their relation to regulation, in general, and even less going beyond the question of whether or not to impose mandatory disclosure, in particular.

According to Cabedo and Tirado (2004), companies are essentially exposed to two types of risks: nonfinancial risks, which are not directly related to monetary assets and liabilities, although they will have an effect on future cash flow losses (business risk and strategic risk) and financial risks, which do have a direct influence on the loss of value of monetary assets and liabilities (market risk, credit risk, liquidity risk and operational and legal risks). Each one of these risks must be quantified so that financial statements can present information on their equity, financial and economic situations together with the business risks to which they are exposed, thereby providing potential users with the most appropriate information necessary for the decision making process to go ahead. The most recent empirical studies conducted on corporate risk reporting (Dobler, 2008) are based on annual reports' content analysis of a various number of listed companies in different countries (Australia, Italy, Canada, Japan, Germany etc.). The main results consist in diverse application of risk reporting requirements and large variation in content and level of detail of voluntary risk reporting (Carlon et al., 2003); voluntary risk reporting is mainly qualitative and there are few disclosures on interrelations between risk factors and their potential impact, but a strong evidence consistent with size effect (Beretta and Bozzolan, 2004); a large variation, particularly in voluntary risk reporting, while risk reporting is mainly qualitative, there are few disclosures on risk assessment and few risk forecasts (Lajili and Zeghal, 2005; Mohobbot, 2005); increasing quantity of risk disclosures over time, but non-compliance with accounting requirements. Even some authors who have seen themselves as following a management accounting approach have, in practice, placed considerable emphasis on its role in generating information on environmental and social contingent factors that impose a risk reporting affecting the decisions of external stakeholders. For example, an Israel and Zimiles study (2003) asserts that from 1996 to 2000, 10% of the Fortune 1000 lost over 25% of its shareholder value within a one-month period. Many of these loses can be attributed directly or indirectly to non-financial issues such as social or environmental.

Uncertainty of information endowment and issues of credible communication can explain restricted risk reporting observed empirically. Linking regulatory attempts to these restrictions implies that regulation may mitigate the incentives-driven restrictions to some extent, but can have adverse effects on risk reporting (Dobler, 2008). In summary, the accounting literature shows a great deal of interest in introducing information on company risks in financial statements. The incorporation of this kind of information within the present disclosure model will provide users with more realistic information, and will facilitate their decisions on which investments to make. We consider the recent practical and policy developments in the disclosure of risk-related information in order to establish the current state of the art of corporate risk disclosure. The incorporation of information on company risks within the present financial statements model will provide users with more realistic information, and will facilitate their decisions on which investments to make.

2. The development of risks and uncertainties reporting over the years

Companies need to assess carefully what are their principal risks and uncertainties, and report on those, together with the approach to managing and mitigating those risks, rather than simply provide a list of all their risks and uncertainties. The disclosure of principal risks and uncertainties is likely to warrant greater attention in near future. The extent and speed of change in market conditions as a result of the financial crisis affecting banks and, more recently, other sectors of the economy, together with unprecedented increases in some commodity prices means that all companies are facing increased, and possibly different, risks when compared to prior years. Experience has shown that risk to a company's business model cannot be disregarded on the grounds that its materialisation would require a fundamental change in the market in which a company operates (FRC, 2008)

As shown, the accounting literature has pointed out the need to report risk. However, few references deal with the problem of how to incorporate information about risk in the present model of disclosure. Furthermore, these references mainly focus on financial risks.

Twenty years ago, the scheme of disclosure did not provide users with information about the risks to which companies are exposed, and which, may affect the future profits of the firm. This lack of information had been highlighted by several accounting institutions. The American Institute of Certified Public Accountants (AICPA, 1987) *Report of the Task Force on Risk and Uncertainties* recognised that users, faced with the uncertain environment in which firms are operating, are demanding information to help them to evaluate company risks related to future cash flows and results, and, consequently, to improve their decision-making processes. Later the Accounting Standards Executive Committee (AcSEC) of the AICPA (1994) prepared a report on the disclosure of information on risk and uncertainty in financial statements. The Statement of Position 94–6 *Disclosure of Certain Significant Risks and Uncertainties* concluded that firms should disclose information on risks and uncertainties in their financial statements. SOP 94-6 requires additional disclosures about the nature of their operations. The disclosures required by SOP 94-6 focus on a company's principal markets, including their locations. Segment information for business enterprises, in contrast, focuses on the nature of the segments' operations and their identifiable assets and the geographic location of assets outside the enterprise's home location. Disclosure of the locations of a business entity's principal markets provides information useful in assessing risks and uncertainties related to the environments in which it operates. The risks and uncertainties associated with selling products and services in various geographic regions may differ significantly. Knowing the environments in which an entity sells its products or provides services helps users of financial reports assess certain risks based on day-to-day national and world events.

The need to inform on risk has also been expressed in the United Kingdom. The first references to this were seen in the Cadbury Report (1992), which recommended that the main risks facing the company be identified, evaluated and managed, and that they be made public as one of the items on the agenda for the reform of the operative supervision and control process in UK companies. Subsequently, the Combined Code (1998) modified the initial requirements set out by the Cadbury and Greenbury reports on the governance of corporations, and pointed to the need for a review of their internal control systems and for the reporting of company risks to shareholders. In answer to the Combined Code, the Institute of Chartered Accountants in England and Wales (ICAEW) published the Turbull Report (1999) to help companies apply principles of the Combined Code, which states that "the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets". This report emphasises the need to disclose the risks facing firms (which are a part of their internal control system) in order to improve management. This need has also been recognised in Canada by Boritz (1990).

The ICAEW (1997) Financial Reporting of Risk: Proposals for a Statement of Business Risk not only reveals the lack of risk information in financial statements, but also formally proposes that risks should be reported. The ICAEW proposes the set of risks to be reported on, and a set of techniques that can be used for quantifying these risks. The concern about the need to report risk gave rise to a study into the situation of the disclosure of risks in United Kingdom firms. The report "No Surprise: the Case for Better Risk Reporting" (ICAEW, 1999) shows that firms disclose most information about their risks through leaflets, whilst the information on risks included in the financial statements is less detailed.

The ICAEW (1997) classifies the risks according to their causal factors, either internal or external factors. The Institute proposes a series of techniques to be used when quantifying risks: the analysis of ratios, concentration measures, tendency analysis, benchmarking, sensitivity analysis and value at risk. However, the ICAEW does not show how these techniques should be used for each of the risks on which firms must report.
The Companies Act 1985 asks simply for a description of the principal risks and uncertainties facing the company. This requirement is less than the disclosures recommended in the Reporting Statement, together with an assessment of how companies are reporting their risks and uncertainties. The Company Act 2006 made changes to the narrative reporting requirements. All companies, other than small, are already required to produce a business review. In the case of quoted companies, the directors will be required – to the extent necessary for an understanding of the business – to report on environmental matters, the company's employees and social/ community issues.

The ASB has assessed how companies are reporting as against the ten main areas of the best practice recommendations contained within the ASB's Reporting Statement on the Operating and

Financial Review. The 1993 Accounting Standards Board (ASB) Statement on the Operating and Financial Review (OFR) established a voluntary and principle-based framework to guide the reporting of business risk, including capital structure, treasury policy, going concern and balance sheet value, taxation, funds from operating activities and other sources of cash, and current liquidity (ASB, 1993). Among those, our interests were in: principal risks and uncertainties and in environmental, employee and social issues, and contractual arrangements/relationships.

Most business risk information was not being disclosed within the annual report, that some firms had decided to resist publication of an OFR, some published one but presented little information, whilst others published one and reported extensively (ICAEW, 2002; Cabedo and Tirado, 2004; DTI, 2004). In response, the ASB Statement on the OFR was revised (ASB, 2003), and subsequently superseded by Reporting Standard (RS) 1 'The Operating and Financial Review', issued 10 May 2005 (Reporting Standard 1, 2005), to coincide with the statutory reporting requirement for quoted companies to publish an OFR for financial years on or after 1 April 2005 (FRC, 2006). Regarding the influence of overseas regulation, from 1 April 2005 the European Union requires all its listed companies, except eligible small companies, to publish a business review within which there must be a discussion of principal risks and uncertainties (DTI, 2007).

The Reporting Statement (paragraph 52) recommends that the OFR should include a description of the principal risks and uncertainties facing the entity together with a commentary on the directors' approach to them. Therefore, the annual report should disclose strategic, commercial, operational and financial risks where these may significantly affect the entity's strategies and value.

The Reporting Statement (paragraph 28) recommends that 'to the extent necessary' to meet the overall requirements of the OFR, the OFR should include information about: environmental matters (including the impact of the business of the entity on the environment); the entity's employees; social and community issues and persons with whom the entity has contractual or other arrangements which are essential to the business of the entity. Meeting the first three recommendations above are often satisfied by companies producing corporate responsibility sections within the annual report. Many companies also produce stand alone Corporate Social Responsibility (CSR) reports which are referenced to from the annual report. The annual report should contain for environmental matters, the entity's employees, and social and community issues the policies of the entity in each area and the extent to which those policies have been successfully implemented.

3. International regulatory aspects of risk and uncertainties reporting in annual reports

The accounting profession in Europe and internationally (ASB – Accounting Standard Board; FEE – Federation des Experts Europeens; IASB – International Accounting Standard Board; ICAEW – Institute of Certified Accountants of England and Wales) has considered these facts and has provided guidance to its members, although the prevailing consensus seems to be that existing financial accounting practices, so long as they are properly applied, are adequate to deal with environmental and social effects on business and do not require change. These bodies of work can be seen as adopting a 'financial accounting' approach, with a focus on reporting to external stakeholders. In Australia, the United States of America, Taiwan, Japan and European Union countries such as France, the Netherlands, UK and Denmark, incentives and requirements to enlarge the scope of conventional corporate financial reporting to include non-financial information are rapidly unfolding (Bushman et al., 2004; Chua, 2007). Some actions are motivated by national environmental and social policy goals, others by investor pressures to obtain a clearer picture of corporate performance. One facet of the risk debates relates to the communication of risk information by companies to stakeholders. Schrand and Elliott (1998) document American Accounting Association/Financial Accounting Standards Board (AAA/FASB) 1997 conference debates that suggested US companies were providing insufficient risk information within their annual reports. The Institute of Chartered Accountants in England and Wales (ICAEW) also noted this risk information gap and issued three discussion documents (1998, 1999 and 2002) encouraging UK company directors to report upon risks in greater depth.

The reporting models analyzed by Dobler (2008) imply three major explanations for restricted risk reporting observed empirically:

- A manager may not report because he does not or pretends not to hold risk information. This relates to models of uncertainty of information availability;
- A manager may not report available risk information either because he cannot credibly do so or chooses to misreport, particularly in connection with forecasts;
- A manager may not report risk information because he fears creating disadvantages for the firm.

Regulators may respond to each of these levels of restrictions. Regulators may require adequate corporate risk management systems to address managerial information endowment or impose enforcement mechanisms to address the credibility of risk reporting. While these measures apply to both voluntary and mandatory disclosure, regulators may mandate risk reporting. While some discretion is inherent in the nature of risk reporting, regulation may limit discretion compared to voluntary reporting by mandating risk disclosures by type and format. Most regimes follow a piecemeal approach. They mandate selected risk-related disclosures referring to specific categories of risks as opposed to requiring comprehensive risk reporting (Dobler, 2008).

Risk reporting requirements of US-GAAP and IFRSs are roughly comparable. Particularities concern disclosures of risk concentration arising from major customers (SFAS 131 Disclosures about Segments of an Enterprise and Related Information), going concern uncertainties (IAS 1 Presentation of Financial Statements), risks associated with a restructuring, for example, termination benefits (IAS 19 Employee Benefits and SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities) and the special clause in IAS 37 Provisions, Contingent Liabilities, and Contingent Assets, which allows to omit some disclosures in extremely rare cases where disclosures can be expected to prejudice seriously the position of the entity in a dispute with other parties. Both regimes use various notions of risk, but do not mandate risk forecasts. Disclosures are located in the notes, focus on contingencies (SFAS 5 Accounting for Contingencies, SOP 94-6 Disclosure of Certain Significant Risks and Uncertainties, IAS 37), financial and market risks and their management (SFAS 133 Accounting for Derivative Instruments and Hedging Activities, IFRS 7 Financial Instruments: Disclosures).

Table 1 US GAAP / IFRS risk reporting requirements

Characteristics	USA	IFRSs
Regulatory approach	Piecemeal approach	Piecemeal approach
Major regulation	SFAS 5, 131, 133; SOP 94-6 SEC Regulations, FRR 48	IAS 1, 37; IFRS 7
Reporting instruments	Notes SEC forms, MDandA	Management commentary proposed
Notion of risk	Various, mainly uncertainty-based	Various, mainly uncertainty-based
Risk management disclosures	Mainly concerning use of financial instruments	Mainly concerning use of financial instruments
Focus of risk disclosures	Financial and market risk, contingencies	Financial and market risk, contingencies
Disclosure of risk concentrations	Financial risk, major customers and other	Mainly financial risk
Disclosure of going-concern uncertainties	Required only by audit standards (SAS 59)	Required in notes
Risk quantification	Required for financial risk, for contingencies, where practicable	Required for financial risk, for contingencies, where practicable
Disclosure of risk forecasts	Not required, encouraged in MDandA	Not required
Negative reports	Not required	Not required
Special opt-out clause	No	Yes (IAS 37.92)

Source: Dobler, 2008

Risk reporting is an emerging reporting challenge in Europe and around the world. Thus, the International Accounting Standard Board (IASB), under rules IAS 32 and 39, and the Financial Accounting Standard Board (FASB), under rule SFAC 133 only establish the compulsory disclosure of market risks arising from the use of financial assets. Likewise, the SEC (1997) obliges listed companies to disclose the market risk arising from adverse changes in interest and foreign exchange rates, and in stock and commodity prices. However, the rules do not refer to any other risks affecting firms, such as non-financial risks and financial risks other than market risks (Cabedo and Tirado, 2004). Even in the presence of regulation on risk information endowment and enforcement, a voluntary risk reporting regime that relies purely on disclosure incentives tends to yield poor risk reports.

The importance of narrative reporting accompanying the financial statements has long been recognised by regulators and standard-setters in a number of major jurisdictions, for example 'Management Discussion and Analysis' (MDandA) in the United States and Canada, 'Management Reporting' in Germany, and a 'Review of Operations and Financial Condition' in Australia. There are also EU legal requirements for narrative reporting. The Accounts Modernisation Directive requires companies to present an annual report that provides 'at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces'. In addition, the Transparency Directive requires – from 20 January 2007 – all securities issuers to provide annual and half-yearly management reports. The annual management report must be in accordance with the provisions of the Accounts Modernisation Directive. The half-yearly management report 'shall include at least an indication of important events that have occurred during the first six months and their impact on the financial statements together with a description of the principal risks and uncertainties for the remaining six months of the financial year'.

The International Organisation of Securities Commissions (IOSCO) endorsed disclosure standards in 1998, one of which established standards applicable to the narrative information that foreign issuers should provide in documents used in initial offerings and listings of equity securities by foreign issuers. In 2003, IOSCO published its 'IOSCO General Principles Regarding MDandA to explain the purpose behind MDandA and to note general precautions for issuers when preparing such disclosure.

At a meeting held in October 2002 between the International Accounting Standards Board (IASB) and its partner national standard-setters, it was agreed that work should begin on a project to examine the potential for the IASB to develop standards or guidance for management commentary (MC). For many entities, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements. Management commentary encompasses reporting that is described in various jurisdictions as management's discussion and analysis (MDandA), operating and financial review (OFR), or management's report.

There was general acknowledgement that guidance on this topic was needed and that preparers of financial statements were looking to both the IASB and IOSCO (and others) to provide it. The IASB asked the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand to provide staff to lead the project, with further members being provided by staff of the ASB, the Canadian Institute of Chartered Accountants (CICA) and the Deutsches Rechnungslegungs Standards Committee (DRSC). The main conclusion of the MC discussion paper is that the IASB can improve the quality of financial reports by developing a standard on management commentary. The project team's proposals for what such a standard should contain are largely similar to those in the ASB's Reporting Statement.

On 23 June 2009 the International Accounting Standards Board (IASB) published for public comment a proposed non-mandatory framework to help entities prepare and present a narrative report, often referred to as management commentary. The exposure draft is open for comment until 1 March 2010. Deliberations of issues raised by respondents is tentatively scheduled to begin in May 2010. Management commentary is an opportunity for management to outline how an entity's financial position, financial performance and cash flows relate to management's objectives and its strategies for achieving those objectives. Users of financial reports in their capacity as capital providers routinely use the type of information provided in management commentary as a tool for evaluating an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives.

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. It is important that management distinguish the principal risks and uncertainties facing the entity, rather than listing all possible risks and uncertainties.
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. 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—both when they constitute a significant external risk to the entity and when the entity's impact on other parties through its activities, products or services affects its performance.

4. Conclusion

Certain disclosures required by international financial reporting standards may and should contain qualitative and sustainable information in risks and uncertainties the entity's activity is affected. To illustrate, the reduction of waste streams leading to lower costs should appear in the form of decreased expenses in the financial report, while revenue from productive use of waste streams should be included as income. Liabilities such as vulnerability to changes in environmental regulation or international labour conventions can be captured in the liabilities section of the balance sheet. On a more general level, economic, environmental and social trends can appear in the sections of financial reports that relate to the discussion and analysis of future risks and uncertainties.

Dobler (2008) confirms that regulation cannot overcome incentives in risk reporting at each level of analysis. If a manager does not report because he has no risk information or pretends not to have any, requiring a minimum level of information endowment through risk management benchmarks the margins for discretion, but cannot eliminate them even in case of verifiable information. For both verified and unverified disclosure, more precise information held by the manager does not necessarily imply more precise risk reporting. This is partly due to both the restrictions to credible disclosure and the possibility of misreporting private risk information when considering unverified disclosure. The empirical findings of Solomon et al. (2000) indicate that institutional investors do not generally favour a regulated environment for corporate risk disclosure or a general statement of business risk. The respondents agree that increased risk disclosure would help them in their portfolio investment decisions. However, for other aspects of the risk disclosure issue they are more neutral in attitude.

Both the accounting literature and the main international accounting organisations recognize the need to complement the information currently supplied by companies with reports on the levels of risk they assume, in order to serve the purposes of users in their decision making processes. However, a formal framework has still not been established within which companies can operate when it comes to deciding which risks they should report, how these risks should be quantified and where they should be presented. The aim of this paper is to offer a systematic view of the risks affecting business activity and of the requirements that accounting and reporting standards refer to so that business report risks in financial statements.

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