The Connected Disciplines of Risk Disclosure and Risk Management
Today’s Presenter

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Agenda

• Introduction
• Risk disclosure—current state and trends
• Enterprise risk management—current state and trends
• Connecting your risk management and risk disclosure initiatives
Lets Talk About Risk

The world will be a more risky place tomorrow than it is today:

• Global financial markets
• Emerging countries and economies
• Security, technology, and data
• Changing climate and environment
• Demographics and other geo-political changes
Managing Risk—A Focus on Strategy and Growth

• Many companies cannot find reliable paths of growth today

• Stock prices fall if investors are not convinced of future growth

• Large company cash reserves at times are a reflection of limited growth projects

• Strategic success and strategic failures are what drive headlines…and correspondingly company valuations
Changes In the Risks Being Managed and Drivers of Valuation

- The drivers of market value have changed significantly.
- The uncertainty of the valuation of intangible assets requires a different approach to risk management.
The Future of Risk—A Prediction

• How organizations disclose risk factors will become more specific and regulated in the future.

• Investors will recognize that organizations that have a more disciplined approach to managing strategy and risk will drive better returns. The flow of capital will go to those companies with the best track record for managing uncertainty in the global marketplace.

• The market will reward those companies who are able to increase the transparency and communication of risk within their extended value chain and quickly identify and respond to environment changes that alter their risk profile.

• The increased focus on risk disclosure will drive a corresponding increase in the importance of enterprise risk management.
SEC Risk Disclosure
SEC Risk Disclosure—The Basics

• Beginning in 2005, the SEC required firms to include qualitative disclosures of risk factors in item 1A in their annual 10-K forms.

• The SEC, under rule 405, requires disclosure of anything considered “material” through annual or quarterly filings.

• Item 503(c) of Regulation S-K requires a registrant to disclose its significant risks and how it is affected by each of them.

• SEC guidance is that risk factors should be specific to the company’s facts and circumstances and not merely general risks that could apply to any company.
Risk Disclosure—Risk Factors

Item 503(c) requires the discussion of risk factors to be “concise and organized logically.” Some companies have used headers to group risks by the type of factors, such as the following:

• Risks related to operational factors
• Risks related to technology factors
• Risks related to economic or market factors
• Risks related to legal and regulatory factor
What Risks to Disclose—The Materiality Principle

- FASB defines materiality as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

- Many firms often rely on what is known as the 5 percent rule. The SEC has stated that this 5% practice should be used only as a loose guideline.
Risk Disclosure—Sample Language

“While we devote considerable effort and resources to shape, analyze and respond to consumer preferences, consumer spending patterns and preferences cannot be predicted with certainty and can change rapidly. If we are unable to anticipate and respond to trends in the market for beauty and related products and changing consumer demands, our financial results will suffer.”
– Form 10-K, filed 3/8/2011

“Disruptions, failures or security breaches of our information technology infrastructure could have a negative impact on our operations.”
– Form 10-K, filed 2/18/2011

“Most of the company’s products compete with other widely advertised brands within each product category. The company also encounters competition from similar and alternative products, many of which are produced and marketed by major multinational or national concerns. The company’s products generally compete on the basis of: specific benefits to customers; marketing (including advertising, promotion, merchandising, packaging and trade spending); product quality; and price.”
– Form 10-K, filed 11/23/2011

“A general economic downturn or sudden disruption in business conditions may affect consumer purchases of discretionary items and/or the financial strength of our customers that are retailers, which could adversely affect our financial results.”
– Form 10-K, filed 8/22/2011
Risk Disclosure—Current State

• Information on section 1a of 10-K’s on average makes up about 10% of the words in a 10-K. There is debate on how informative it is.

• Firms do not have to disclose the likelihood that a given risk would occur nor do they have to disclose that impact that this risk would have on the business if it did in fact occur.

• The most valuable and significant non-financial information is under a firms control. For most firms they will want to hold it under 'lock and key' until legally required to disclose it.
Many say the topic of risk factors is influenced or directed by legal counsel.

Q10. If counsel is significantly involved in determining disclosures included in a filing with the SEC or the footnotes to the financial statements, please identify what topics are influenced or directed by legal counsel?

• Although the Private Securities Litigation Reform Act of 1995 (“PSLRA”) provides a safe-harbor for forward-looking statements made by companies in their disclosures, many legal counsels influence what risks are disclosed.

<table>
<thead>
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<th>Topic</th>
<th>Total (n = 139)</th>
<th>Public (n = 102)</th>
<th>Private (n = 36)</th>
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<tr>
<td>Risk factors</td>
<td>75%</td>
<td>59%</td>
<td>81%</td>
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<tr>
<td>Fear of litigation by third parties</td>
<td>33%</td>
<td>16%</td>
<td>47%</td>
</tr>
<tr>
<td>(such as class action suits)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Other</td>
<td>9%</td>
<td>9%</td>
<td>11%</td>
</tr>
</tbody>
</table>
Risk Disclosure—Forward Looking Statements

• If a forward-looking statement is immaterial or accompanied by meaningful cautionary language identifying important factors that could cause actual results to differ from those in the forward-looking statement, or if a plaintiff cannot prove that the Company knew the forward-looking statement was false or misleading, there is no liability for the forward-looking statement.

• The SEC has recently taken the position that language cues ("we believe" or "we expect") are generally sufficient to identify forward-looking statements.

• Boilerplate cautionary language is not meaningful. Cautionary statements must be specific, substantive and tailored.
Risk Disclosure—Current Challenges

• Investors frequently have said that risk factors are generic and confusing. The most important risk factors often are not presented first, and readers have a hard time determine whether a risk is likely to become a reality.

• The SEC staff also has questioned risk factor disclosures that could apply to any public company, saying they are not sufficiently specific or detailed to address the facts and circumstances of a particular company.

• In recent years, the SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language.

• In an April 11, 2014, speech highlighting the SEC staff’s “disclosure effectiveness” initiative, a staff member indicated that “risk factors could be written better —less generic and more tailored — and they should explain how the risks would affect the company if they came to pass.”

• Accordingly, the SEC staff routinely asks registrants to replace boilerplate risk disclosures with a discussion of the risks that specifically affect the registrant and their possible impact on the registrant’s business.
Risk Factors

Example of an SEC Comment

Please ensure that your risk factors fully describe the material risks faced by you and explain specifically how such risks are related to your business.

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Accordingly, the SEC staff routinely asks registrants to replace boilerplate risk disclosures with a discussion of the risks that specifically affect the registrant and their possible impact on the registrant’s business. This discussion may be supplemented with quantitative information to provide additional context about the risks. In addition, the staff often asks registrants whether they have (1) discussed all relevant risk factors and (2) provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty. The staff also reminds registrants that the title of each risk factor should adequately describe the related risk.
Risk Disclosure—Current Challenges

• In addition, the staff often asks registrants whether they have (1) discussed all relevant risk factors and (2) provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty.

• The staff also reminds registrants that the title of each risk factor should adequately describe the related risk and their possible impact on the registrant’s business.
Increased Risk Disclosure Trends—SEC


• Climate change: While the SEC has few requirements about sustainability reporting, the SEC did propose guidelines for companies to disclose climate change information in 2010.

• According to a 2014 report by the sustainability non-profit Ceres, “41 percent of S&P 500 companies failed to address climate change in their 2013 filing.”
Increased Risk Disclosure—EU

• The European Parliament recently passed a law that will require thousands of large companies based in the European Union (EU) to disclose information about environmental, social and governance (ESG) factors in their annual reports.

• The new EU disclosure requirements will apply to all publicly traded companies with at least 500 employees.

• Must disclose all "relevant and material information on policies, outcomes and risks, including due diligence that they implement, and relevant non-financial key performance indicators."

Source: Disclosure of non-financial and diversity information by large companies and groups - Frequently asked questions, (2014). European Commission.
Risk Management
Risk Management

Risk management is a dynamic process in which information flows from line managers up to senior managers who monitor progress and, when necessary, develop action plans and send instructions back down to line managers.

- Environmental performance
- Social and employee-related matters
- Human rights policies
- Anti-corruption and bribery issues
- Diversity on the board of directors
Enterprise Risk Management—COSO Definition

“... a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

Risk Management—Current State

• 30% describe their ERM process as systematic, robust, and repeatable with regular reporting of top risks to the board. That percentage is higher (55%) for large organizations and public companies (59%).

• 71% of the largest organizations use written reports to communicate risks information to senior executives (73% of public companies). That was true for only 39% of the full sample.

• 27% use scheduled agenda discussion time at management meetings to communicate key risks to senior executives. That percentage ranges between 35% and 37% for large organizations, public companies, and financial services organizations.

• 59% of the organizations report risks to senior executives via ad hoc discussions at management meetings.

• 41% admit to not being “at all satisfied” or “minimally” satisfied with the nature and extent of the reporting of key risk indicators to senior executives.
Risk Management—You May Already Be Doing It

How often are risk management considerations factored into your organization’s strategic planning decisions?

- **27%** Constantly, in all strategic planning decisions/sessions
- **39%** Often, in the majority of strategic planning decisions/sessions
- **11%** At least annually at the strategy planning session
- **20%** Rarely, only in key strategic planning decisions/sessions
- **3%** Do not know/consideration of risk management in strategic planning varies widely across business units

86% An overwhelming majority of survey respondents said that risk management considerations are to some degree factored into strategic planning decisions.

Figure 4. Which of the following risk oversight activities does your company’s board of directors or board risk committee(s) perform?

- Review regular risk management reports: 98%
- Review and approve overall risk management policy and/or ERM framework: 81%
- Approve the risk appetite statement: 78%
- Review individual risk management policies, e.g., for market, credit, liquidity, or operational risk: 75%
- Review corporate strategy for alignment with the risk profile of the organization: 73%
- Review management’s steps to remediate any noncompliance with risk management policy: 68%
- Define risk management reporting lines and independence: 58%
- Conduct executive sessions with CRO: 57%
- Help establish and imbed the risk culture of the enterprise; promote open discussions regarding risk: 51%
- Review incentive compensation plans to consider alignment of risks with rewards: 49%
- Review the charters of management-level risk committees: 43%
Risk Management—The Growth of ERM Programs

Figure 7. Does your organization have an ERM program or equivalent?

- 2012: 62% Yes, program in place, 21% Yes, currently implementing one, 8% No, but plan to create one
- 2010: 52% Yes, program in place, 27% Yes, currently implementing one, 14% No, but plan to create one
- 2008: 36% Yes, program in place, 23% Yes, currently implementing one, 23% No, but plan to create one
- 2006: 35% Yes, program in place, 32% Yes, currently implementing one, 18% No, but plan to create one

Connecting Your Risk Disclosure and Risk Management Initiatives
A Convergence Of Factors

Risk disclosure trends

• Investors will continue to demand more transparency
• SEC and global regulations may force a more refined approach to risk disclosure
• Supporting evidence for disclosure of risk may follow the trend for internal controls and other operational data

Risk management trends

• There is a greater focus in the past 5 years of risk management at the operational and board level
• Increased and improved information at the board level may increase the pressure for greater disclosure
• Supporting evidence for disclosure of risk may follow the trend for internal controls and other operational data
Considerations for Maturing the Process

• Invest in a more formal approach to enterprise risk management (ERM) to better manage the uncertainty in your business

• Leverage some of the disciplines that have been adopted to manage your SOX reporting processes for your ERM initiatives

• Utilize your ERM findings to prioritize and support your risk disclosure information

• Mature your process by taking an evidence-based approach to risk management
Take An Evidence-Based Approach to Risk Management

Evidence-based risk management is the practice of integrating evidence collection, organization, and analysis for the purposes of risk identification, assessment, and control.

Companies fail to collect the evidence they can trust for several reasons:

• The individuals charged with the work aren’t told that they need to collect evidence, and/or there is no consistent way to check their progress throughout the process

• They lack a consistent, cost-effective way to collect and organize the evidence

• They struggle with multiple versions of key documents and templates which often have inconsistent data

• They lack a single repository where they can store, organize, and access the evidence quickly and easily
**Benefits of Evidence-Based Risk Management**

• Evidence-based risk management provides the ability to trust the results of ERM programs. Collecting evidence also provides an effective reminder of the steps we must take to earn trust.

• It’s evidence that enables managers of public companies to be confident and demonstrate to their auditors and senior executives that the risks they are disclosing are material.

• However, if the act of collecting, organizing, or managing evidence is too hard, it does not get done, at least not consistently, and therein lies the problem. New cloud-based tools have proven that they can help streamline and simplify the processes, and in doing so, make people’s jobs easier.
Next Steps

• Consider how you will integrate your risk management with your financial disclosure, performance measurement and reporting initiatives.

• Invest in processes to better define actionable risk tolerances that fall within the scope of your established risk appetite and use them to establish stronger accountability and discipline in the organization.

• Evaluate how you will handle the requirements that both disclosure and performance management will be increasingly forward-looking for executive management and the board of directors.

• Mature your processes and technology with the anticipation that everyone in the organization will be playing some role in enterprise risk management.