Risk paragraph
Audit and Reporting Quality

October 2014

Contents

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The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers’ and companies’ confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

1. Management summary

For the users, it is important that companies report transparently on relevant risks (strategic, operational, financial, legislative and regulatory and financial reporting) and their readiness to accept risks (known as risk appetite). Moreover, a number of recent business incidents have clearly shown the importance to users of transparent reporting on risk management and internal controls. The AFM accordingly conducted a thematic review of the risk paragraph.

The AFM's findings as a result of the review it conducted were as follows:

- The prioritisation of risks can be improved
- The disclosure of the risk appetite can be improved
- More attention to the quantification of risks and sensitivity analyses is needed
- Reporting of the evaluation of the operation of the risk management system can be improved

The prioritisation of risks can be improved
In most cases, the description of risks seems complete. However, it is also important to the users that companies explicitly state which risks are the most significant. Our review shows that most AEX companies include a prioritisation of risks. Only a few of the AMX, AScX and locally listed companies explicitly state which risks are most important to them. The AFM takes the view that the information value of the risk paragraph could be increased by stating which risks are the most important as well as giving a description of the relevant risks.

The disclosure of the risk appetite can be improved
Information on the extent to which companies are willing to take risks is very important to users. This shows the amount of risk a company is willing to take to achieve its goals. Our review shows that approximately half of the AEX and the locally listed companies devote attention to risk appetite. Among the AMX and AScX companies, it is notable that only a limited number mention in the risk paragraph their attitude to the risks they describe. The AFM definitely sees clear room for improvement here.

More attention to the quantification of risks and sensitivity analyses is needed
Only a limited number of companies quantify the potential or actual effects of one or more risks. This applies to around 50% of the AEX companies and a lower proportion of the other companies. In addition to quantification of risks, a sensitivity analysis can also increase the information value. Our review shows that only a few companies provide a sensitivity analysis, and that if they do, this is restricted to the category of financial risks such as interest rate risk or currency risk. The AFM recommends that companies devote more attention to quantification of risks and sensitivity analyses where appropriate.

Reporting of the evaluation of the operation of the risk management system needs to be improved

Almost all the companies reviewed provide a description of the measures taken to manage their principal risks and uncertainties. The AFM notes that only a limited number of companies report any shortcomings, changes and improvements to their risk management systems. In the context of the evaluation of the risk management system, it would also help users if the issues in the management letter are addressed. Although a large number of companies do not discuss the substance of the evaluation of the risk management system, they do state that the evaluation has been discussed with the supervisory board. The substance of the evaluation and the results of these discussions are, however, seldom stated. The AFM concludes that the reporting of the evaluation of the operation of the risk management system by companies is too limited, even though this concerns information that is relevant to users. The AFM recommends that companies devote more attention to reporting the evaluation of their risk management systems, including any shortcomings and planned improvements.

2 Rationale, objectives and population

2.1 Rationale

For users, it is important that companies report transparently and comprehensively on relevant risks, their risk appetite and the way in which they respond to fast-changing strategic, operational, financial and compliance risks for the company. Moreover, a number of recent business incidents have clearly shown the importance to users of transparent reporting on risk management and internal controls.

2.2 Objectives

The objective of the review is to improve the quality of the financial reporting in the annual report with respect to the risk paragraph. The aim is that the risk paragraph should more frequently meet qualitative considerations such as relevance and completeness. Users want to know the principal risks to the company's business (in quantitative and qualitative terms) and the extent of the company's risk appetite. Moreover, there must be transparent communication regarding risk management and internal controls.
Lastly, the review will serve as a baseline against which future improvements can be measured.

2.3 Population: 30 companies

The risk paragraph thematic review has been conducted on the 2013 financial reporting of public companies incorporated under Dutch law whose shares are listed on a regulated market in the Netherlands. We selected 30 companies on the basis of sectoral classification. The sample consists of seven or eight companies from each index (AEX, AMX, AScX and Local).

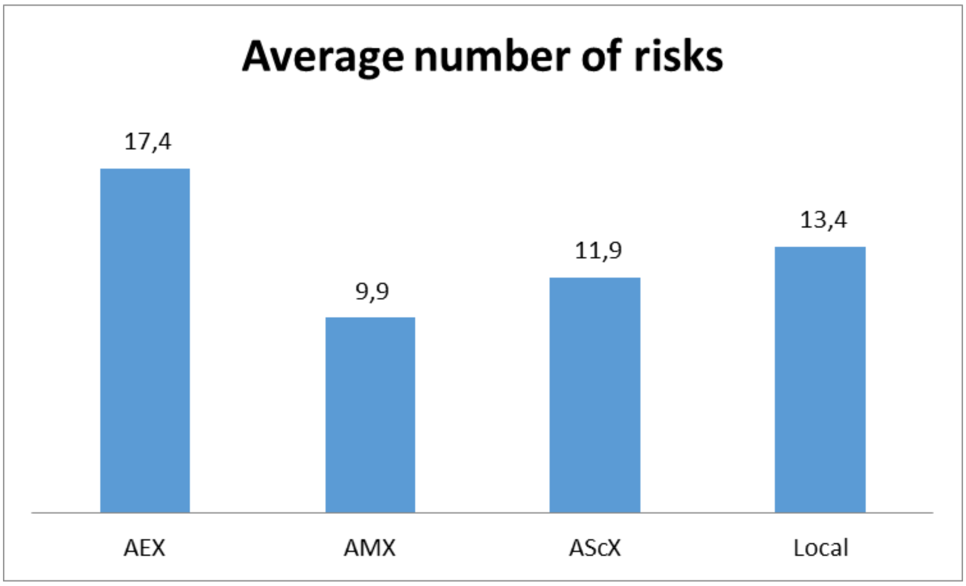
3 Key review results

The results are given below. This section also lists certain ‘good practices’[1]. These good practices are intended to provide examples of how a company can report on the risks it faces in a manner specific to its own situation. The AFM hopes these good practices will inspire companies and assist them in the transparent disclosure of their risks.

3.1 The prioritisation of risks can be improved

Looking at the risks described, it is notable that it is mostly the AEX companies that describe a large number of risks and the AMX companies that describe the fewest risks.

Figure 1: Average number of risks



In most cases, the description of risks seems complete. As stated in the COSO framework, the Dutch Corporate Governance Code and the DASB Guideline 400 Annual Report[2] the following categories are important in the identification of the principal risks:

- Strategy
- Operational activities
- Financial risks

[1] The good practices cited in this report are examples of specific disclosures from existing financial statements and annual reports. The AFM hopes that other companies will be inspired by these good practices to increase the quality and relevance of their own disclosures. The good practices quoted should not be seen as a standard or as the only correct substance of existing or future disclosures. Other formulations to comply with legislation and regulation are possible. The inclusion of good practices in this report does not imply any judgement by the AFM regarding the financial statements in question as a whole.

[2] Guidelines for annual reporting, 400 Annual Report (amended in 2014).

- Legislation and regulation
- Financial reporting

Table 1 shows the extent to which companies describe principal risks in their reporting. Strategy, operational and financial risks score relatively high. Almost all the companies describe these risks. Risks relating to legislation and regulation and financial reporting risks receive relatively the least attention.

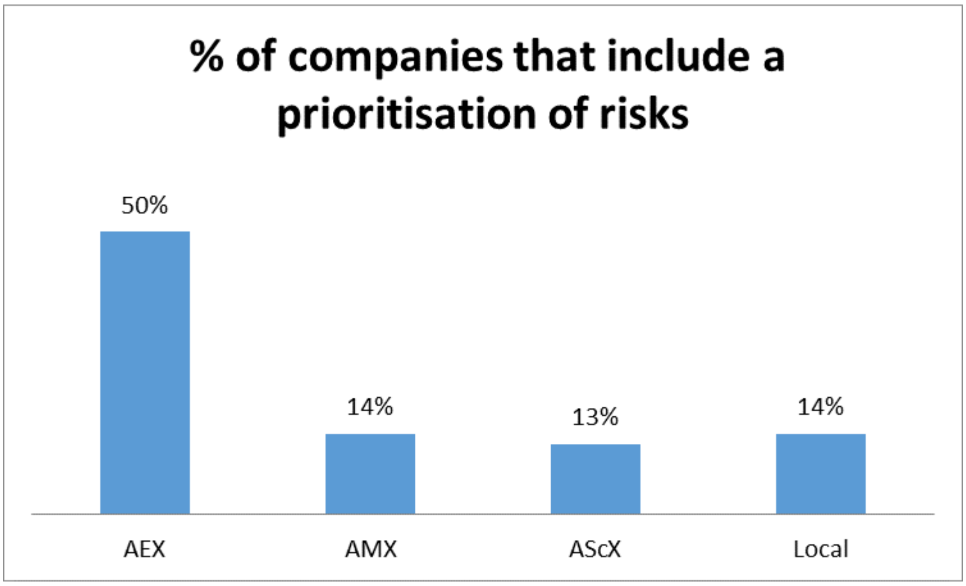
Table 1: % of companies that describe risks

% of companies that describe risks	**AEX**	**AMX**	**AScX**	**Local**
Strategic risks	88%	100%	75%	100%
Operational risks	100%	100%	100%	100%
Financial risks	100%	100%	75%	100%
Risks relating to legislation and regulation	75%	71%	50%	86%
Financial reporting risks	88%	43%	50%	71%

However, it is also very important to users that companies explicitly state which risks are the most significant. This enables the user of the annual report to form a good impression of potential events or developments that could significantly affect the company's result, financial position or continuity.

Our review (see figure 2) showed that AEX companies relatively frequently include a prioritisation of risks. Only a few of the AMX, AScX and local companies explicitly state which risks are most important to them.

Figure 2: % of companies that include a prioritisation of risks



The AFM takes the view that the information value of the risk paragraph could be enhanced by making it clearer which risks are the most important rather than simply providing a list of all potential risks without any prioritisation.
In our opinion, the company does not however have to restrict itself to listing its top 5 risks, since in that case information on other real risks may be lost. To avoid this, the principal risks can be made visible in other ways, by mentioning them first or printing them in bold type.

3.2 The disclosure of the risk appetite can be improved

The extent to which companies are willing to take risks is very important to users. This shows the amount of risk a company is willing to take to achieve its goals. The risk appetite is also a guideline for whether measures are taken to manage risks and uncertainties or not.
In table 2, one can see that the AEX companies devote relatively the most attention to risk appetite. This is due to the fact that the AEX companies include a number of financial institutions that are obliged to devote more attention to risk appetite under the Banking Code.

Table 2: % of companies that describe risk appetite

% of companies that describe risk appetite	AEX	AMX	AScX	Local
Strategic risks	50%	29%	25%	57%
Operational risks	50%	29%	13%	57%
Financial risks	63%	29%	25%	57%
Risks relating to legislation and regulation	50%	29%	13%	29%
Financial reporting risks	50%	14%	25%	14%

Among the locally listed companies as well, more than 50% devote attention to their risk appetite. Only a limited number of AMX and AScX companies include information in the risk paragraph on their attitude to the risks described. The AFM sees clear room for improvement here.

The following example of good practice concerns a disclosure with respect to risk appetite. By using a ranking from low to high, the extent to which the company is prepared to take certain risks is made clear.

Good practice 1: Risk appetite (Koninklijke Vopak N.V. 2013 annual report page 75)

Risk category (COSO)	Strategic pillars Vopak	Vopak's risk-reward appetite
Strategic risks	Growth leadership Customer leadership	**Moderate to high:** right balance between risk and long-term reward
Operational risks	Operational excellence	**Low:** on safety issues **Moderate:** on other areas/topics with alignment of targets and related cost, and a clear focus on sustainable EBIT growth
Compliance risks	Operational excellence	**Low:** full compliance with legal, regulatory and political environments
Financial reporting risks		**Low:** full compliance with financial reporting rules and regulations

3.3 More attention to the quantification of risks and sensitivity analyses is needed

Based on the information shown in table 3, the AFM notes that only a limited number of companies quantify the potential or actual effects of one or more risks. In cases where a company has included a quantification, this mainly concerns financial risks, which is due to the obligations under IFRS to provide further quantification of financial risks in particular.

Table 3: % of companies that quantify risks

% of companies that quantify risks	AEX	AMX	AScX	Local
Strategic risks	25%	14%	0%	14%
Operational risks	13%	0%	0%	0%
Financial risks	50%	43%	0%	29%
Risks relating to legislation and regulation	25%	14%	0%	0%
Financial reporting risks	13%	14%	25%	29%

In addition to quantification of risks, a sensitivity analysis can also increase the information value. Our review shows that companies provide sensitivity analyses to only a limited extent. If a sensitivity analysis is provided, this usually concerns the category of financial risks as a result of the application of IFRS 7. The AFM recommends that companies should also provide sensitivity analyses for other risk categories such as strategic and operational risks if appropriate.
This could be presented in a combined overview as shown in the example of good practice cited below. The overview below shows both a sensitivity analysis for financial risks and the sensitivity in relation to operational risks.

Good practice 2: Sensitivity analysis (Randstad Holding N.V. 2013 annual report page 84)

sensitivity

amounts in millions of €

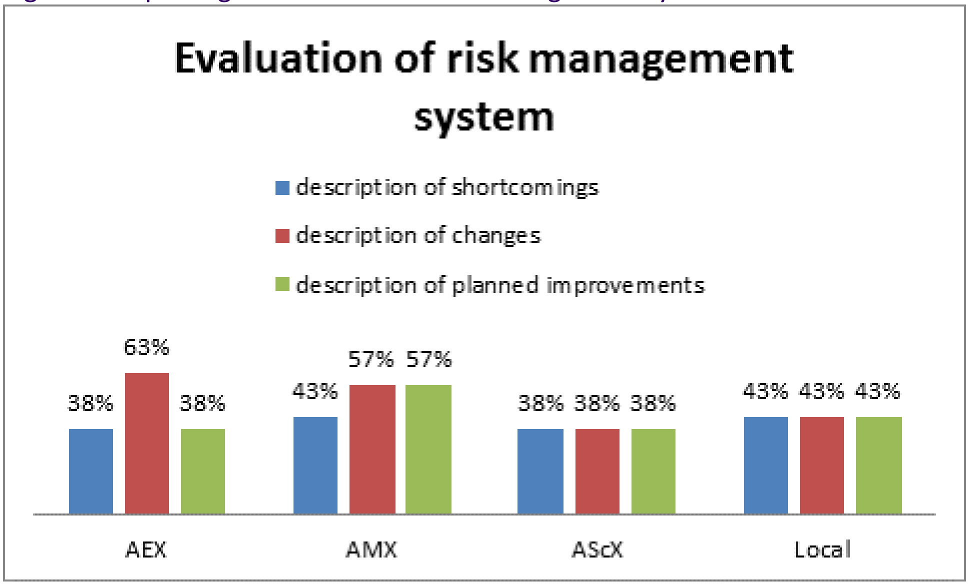
	change	impact	on	assumption FY 2013
Revenue	+/-1%	+/- € 30 million	EBITA	Flat gross margin and no change to cost base
Revenue	+1%	+ € 15 million	EBITA	Flat gross margin and target 50% conversion
Revenue	-1%	- € 15 million	EBITA	Flat gross margin and target 50% recovery
Gross margin	+/-0,1%	+/- € 17 million	EBITA	Flat revenue and no change to cost base
Gross margin	+0.1%	+ € 8 million	EBITA	Flat revenue and target 50% conversion
Gross margin	-0.1%	- € 8 million	EBITA	Flat revenue and target 50% recovery
Operating expenses	+/-1%	+/- € 25 million	EBITA	
USD	+/-10%	+/- € 14 million	EBITA	Stable revenue and margin in US
GBP	+/-10%	+/- € 1 million	EBITA	Stable revenue and margin in UK
JPY	+/-10%	+/- € 3 million	EBITA	Stable revenue and margin in Japan
Interest rate	+/- 100 bp	+/- € 10 million	Financial charges	Average net debt 2013
Net debt	+/- € 100 million	+/- € 1 million	Financial charges	Stable interest rates

3.4 Reporting of the evaluation of the operation of the risk management system needs to be improved

The review shows that apart from one locally listed company, all the companies reviewed describe the measures taken to manage their principal risks and uncertainties. Approximately half of the companies state the framework or system of standards (for instance, the COSO framework) used in the evaluation of the internal risk management and controls system. It is mainly the AEX companies that disclose which framework is used.

Under the Dutch Corporate Governance Code, the management board has to evaluate the design and operation of the risks management system and any significant changes thereto at least once a year. The DASB Guideline 400 Annual Report also states that companies must state whether and if so what improvements have been made to the company’s risk management system.

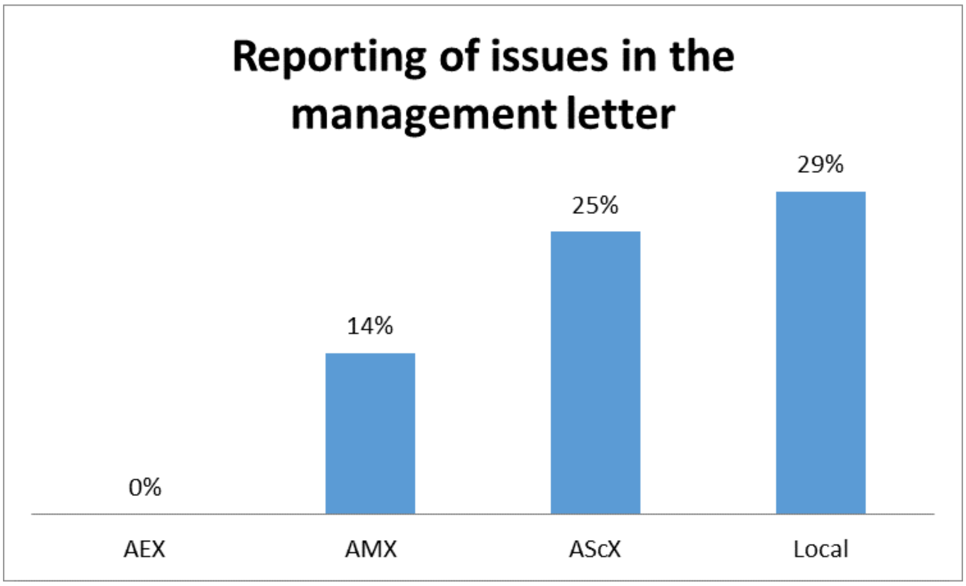
Figure 3: Reporting of evaluation of risk management system



Looking at how companies report their regular evaluation of their risk management system, the descriptions of the results of the evaluation are limited. There is little attention paid to any shortcomings, significant changes and any important changes that are planned.

In the context of the evaluation of the risk management system, it could also help users if companies were to address the issues in the management letter in the risk paragraph. We accordingly included consideration of the management letter in our review. As can be seen from figure 4 on the next page, transparency with respect to the management letter is limited.

Figure 4: Reporting of issues in the management letter



Nearly all the companies state that their risk management and controls system gives a reasonable degree of certainty that the financial reporting does not contain any material misstatements and that the system has operated effectively.

The results of the evaluation of the operation of the risk management system must be discussed with the supervisory board or the audit committee. Although a large number of companies do not discuss the results of the evaluation of the risk management system, they do state that the evaluation has been discussed with the supervisory board. The substance of the evaluation and the results of these discussions are however seldom stated.

The AFM concludes that the reporting of the evaluation of the operation of the risk management system by companies is too limited, even though this concerns information that is relevant to users. The AFM accordingly recommends that companies devote more attention to reporting the evaluation of their risk management systems, including any important shortcomings and important planned improvements.

An example of good practice regarding planned changes is cited on the next page. The company in question (Heijmans) provided an overview of measures and actions to be taken in 2014 in addition to its evaluation of the risk management system and the changes implemented in 2013:

Good practice 3: Planned improvements (Heijmans N.V. 2013 annual report page 75)

Focus of risk management in 2014
Many of the items of attention and actions in 2013 will be followed up in 2014, with the addition of certain other actions and/or measures. In practice, this means:

- Risk management with respect to complex projects in all segments will be further intensified, with adequate attention from the Executive Committee and corporate control;
- Continuation of the 'Fit for Cash' programme and the realisation of the divestment programme at Property Development;
- Continued implementation of the 'Improve the Core' programme with respect to tender management, project management, procurement and sales;
- Continuation of the GO! safety programme;
- Improvement of the reporting structure with respect to cross-sector projects or projects involving parties outside the Group;
- Review of the risk framework with input from the 'Improve the Core' programme;
- Working out the practical details for rolling out the ERP system to other sectors (after Roads);
- Intensification of the central risk function;
- Certain refinements in the prevention of fraud and integrity issues;
- Continued strengthening of the role of project administrators and project controllers;
- Continued attention to the observance of control measures with respect to illegal labour/WKA with additional attention to observance by sub-contractors of statutory requirements regarding pay and working conditions for the workforce.

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