Draft

German Accounting Standard No. 5

Draft-GAS 5

Risk reporting

Status: 24 November 2000

All interested persons and organisations are invited to provide their comments by **Monday, 22 January 2000**. Comments received will be published on the GASC homepage, unless accompanied by a specific request not to publish them.

Comments should be forwarded to the:

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German Accounting Standards Board (GASB)

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Invitation to Comment

The GASB invites all interested persons and organisations to provide comments before 22 January 2001. Comments may be sent on each of the issues dealt with in the draft Standard. In particular we would appreciate comments on the following questions relating to specific paragraphs of the draft.

Scope (paras. 1-7)

Question 1:

The scope of the draft Standard relates to all parent enterprises, which are required to report in their group management report on the risks of future developments in accordance with § 315 (1) 2nd Hs. HGB. The draft Standard should also be applied when reporting under § 292a HGB.

a. Do you agree with the scope of the draft Standard?
b. If not, which scope would you recommend?
c. Do you agree that the draft Standard should also be applicable for management reports prepared in accordance with § 289 (1) 2nd Hs. HGB (i.e. management reports of individual enterprises)?

Definitions (para. 8)

Question 2:

Risk is defined in the draft Standard as the possibility of a future negative impact on the economic position of a group.

a. Do you agree with this definition?
b. If not, what is your recommended definition? Please give reasons for your recommendation.
c. Should risk also be defined in dependence on the objectives of an enterprise?

Procedures (para. 9 et seq.)

Question 3:

The draft Standard's procedures are worded in an intentionally general way so as to cater for the specific risk reporting requirements of different enterprises and industries.

a. Do you agree with this approach?
b. Are there any arguments why the procedures should be made more specific?
c. Should in your opinion any further procedures be included? If yes, please name those procedures.

Question 4:

The draft Standard requires enterprises to disclose any risks threatening their existence and any concentrations of risk.

a. Should the draft Standard require mandatory disclosure of any other types of risk?
b. If so, which ones?

Question 5

The draft Standard does not lay down a specific categorisation of risks which must be followed, but rather gives an example in the appendix.

a. Do you agree that each enterprise should report on risks as they are categorised internally as part of risk management procedures?
b. If not, do you consider that the draft Standard should classify different categories of risks and that reporting should be based on this?

Question 6

The draft Standard requires that risks should be quantified where reliable and recognised methods exist, where quantification can be performed in a way economically justified and where quantification could affect the decisions of the users of the group management report.

a. Do you agree with this approach?
b. Do you agree with the view that under this approach at present only financial risks should be quantified?
c. Would it be preferable for risk quantification to be dealt with in the form of a recommendation?

Question 7

The draft Standard requires that generally risks should be reported after taking into account any risk reduction measures. If, however, the risk reduction measures do not protect the enterprise with certainty, the draft Standard requires that a description should be given of the risks before the effect of such measures and that the measures themselves should also be described.

a. Do you agree with this approach?
b. If not, should the draft Standard require disclosure of risks before risk reduction measures?
c. Do you agree that it should only be necessary to report on risks covered by accruals, provisions or liabilities, where this is necessary to evaluate the overall risk situation of the group?

Question 8

The draft Standard requires that risk assessment should be based on an appropriate forecast period for each risk.

a. Do you agree with this general requirement?
b. Do you agree that a period of one year should be used as the forecast period for risks threatening the existence of an enterprise?
c. Do you agree that a period of two years should be used as the forecast period for other significant risks in general?
d. Do you consider that a longer forecast period is more appropriate in the case of enterprises with longer market cycles or involved in complex major projects?

Question 9

In order to allow a better assessment of risks, enterprises may also make disclosures about opportunities.

a. Do you agree with this rule?
b. What are the arguments against making disclosures about opportunities?

Question 10

The draft Standard requires that information is presented about risk management in an appropriate form. The strategy, procedures and organisation of the risk management system must also be addressed.

a. Do you agree with this requirement?
b. Do you consider that more detailed information should be provided in the group management report about risk management?

Question 11

Information about risks is required to be presented as a rule in a self-contained section of the group management report. However, extensive repetition of information provided elsewhere in the consolidated financial statements or in other parts of the group management report should be avoided.

a. Do you agree that references do not impair the requirement that information about risks should be provided in a self-contained section of the group management report?
b. If not, what are the arguments for requiring information to be repeated and for discouraging the use of references?

Preface

German Accounting Standards Board

The German Accounting Standards Board (GASB) has been mandated to develop principles for financial reporting in consolidated financial statements in accordance with the principles of proper bookkeeping, to advise Parliament on the development of financial reporting and to represent the Federal Republic of Germany on international accountancy bodies. It has seven members appointed by the Administrative Council of the German Accounting Standards Committee e. V. (GASC) as independent experts with proven expertise in the areas of national and international financial reporting.

Note on application

The Standards relating to consolidated financial reporting have been adopted in a public meeting by the German Accounting Standards Board after careful examination of all relevant circumstances, in particular of the principles of proper bookkeeping, and taking account of the comments received, and after carrying out hearings. Once the Standards have been published in the authoritative German version by the Federal Ministry of Justice in accordance with § 342 (2) of the Commercial Code (HGB using its German abbreviation), they are to be presumed to represent proper accounting principles for consolidated financial reporting. Since proper accounting principles are intended to guarantee that statutes are applied in accordance with their intended purpose, they are subject to constant change. Every user is therefore advised to examine carefully on applying the Standards whether their application corresponds to the respective statutory aim, taking account of all the circumstances of the individual case.

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Publisher

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List of abbreviations

AICPA	American Institute of Chartered Public Accountants
AktG	Aktiengesetz (German Stock Corporation Law)
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
GAS	German Accounting Standard
GASB	German Accounting Standards Board
GASC	German Accounting Standards Committee e.V.
HGB	Handelsgesetzbuch (German Commercial Code)
Hs.	half-sentence
IAS	International Accounting Standard
IASC	International Accounting Standards Committee
para.	paragraph
PublG	Publizitätsgesetz (Disclosure Act)
SEC	Securities and Exchange Commission
SOP	Statement of Position
US GAAP	United States Generally Accepted Accounting Principles

Draft German Accounting Standard No. 5

Risk reporting

*The principles are set out in **bold type**. They are explained in the following paragraphs which are printed in standard type. The principle of materiality is to be observed in applying the Standard.*

Scope

1.
This Standard should be applied in reporting risks affecting the future developments of a group in its management report.

2.
Risk reporting should provide the users of the group management report with information which is both relevant for decision-making and reliable. This information should allow users to form an appropriate picture of the risks affecting the future developments of the group.

3.
This Standard applies to all parent enterprises which are required to report on the risks affecting the future developments of a group in accordance with § 315 (1) 2nd Hs. HGB.

4.
In accordance with § 315 (1) HGB the group management report should, as a minimum, describe the course of the business and the state of the group so that a factually accurate picture is presented. In addition the risks affecting future developments should be dealt with.

5.
This Standard applies to all parent enterprises which are either limited liability companies (§ 290 HGB) or enterprises equivalent to such companies (§ 264 a HGB) and to enterprises which are required to present consolidated financial statements in accordance with § 11 PublG.

6.
This Standard on risk reporting should also be applied when enterprises prepare exempting consolidated financial statements in accordance with § 292a HGB.

7.
This Standard applies to enterprises from all industries unless specifically regulated in other Standards.

8.
It is also recommended that the Standard is applied to management reports prepared in accordance with § 289 (1) 2nd Hs. HGB.

Definitions

9.
The following terms are used in this Standard with the meanings specified:

A *risk* is the possibility of a future negative impact on the economic position of a group.

An *opportunity* is the possibility of a future positive impact on the economic position of a group.

The economic position of a group is also dependent on the future success of its business. Whether future developments have a positive or negative impact should be assessed in relation to the economic position of the group at the balance sheet date. In addition, risks are relevant that can have an impact on the enterprise's expectations of anticipated developments as depicted in the group management report ("Prognosebericht").

***Risk categories* combine risks which are similar and related to each other from an organisational or functional point of view.**

***Risk management* is a comprehensive set of control procedures covering all activities of an enterprise; these procedures are based on a defined risk strategy applying a systematic and consistent approach with the following components: identification, analysis, measurement, control, documentation and communication as well as the monitoring of these activities**.

Risk management must be an integral component of the business, planning and control processes. It should be linked with other management systems and be supported in particular by the following functions: business planning, controlling and internal audit.

Procedures

10.
The contents and scope of the report should depend on the specific circumstances of the group and its enterprises as well as on the market and industry specific environment.

11.
The information provided in the risk report should focus first and foremost on the specific circumstances of the group and on the risks affecting its business activities.

12.
A risk which threatens the existence of the group should be clearly described as such.

13.
Information should be provided in particular about concentrations of risk.

14.
Examples are: dependence on individual customers, suppliers, products or patents.

15.
Individual risks should be classified in a suitable manner into risk categories. This should be based on the risk categorisation used internally for the purposes of risk management.

16.
An example of the way risks could be categorised is shown in Appendix A.

17.
The information provided on risks should be self-contained. Individual risks and the possible consequences of such risks should be described.

18.
The way in which risks are presented should reflect their significance to the group. It may be helpful to evaluate the probability of occurrence of the risks and to quantify their possible effect.

19.
Risks should be quantified where this can be done with reliable and recognised methods, where it is economically justifiable and where quantification could affect the decisions of the users of the group management report. In this case, the models and assumptions used should be described.

20.
The requirement for risks to be quantified applies effectively therefore only to financial risks.

21.
Where it is important for the assessment of individual risks, the risk should be described before taking into account the effect of any risk reduction measures to mitigate risk. A description of the measures should also be provided.

22.
If a specific risk can be mitigated reliably by a particular action e. g. by entering into a contract or taking up insurance coverage, it is only necessary to report the residual risk. If this is not the case, the risks should be disclosed before taking into account the effect of any risk reduction measures to mitigate risk and the measures themselves should also be described. Where, for example, risks are covered by write-downs or provisions recognised in the financial statements, disclosures are only required to be made if this is significant for the overall assessment of the risk position of the group.

23.
Risk assessment should be based on an appropriate forecast period for each risk.

24.
In the case of risks threatening the existence of an enterprise, the forecast period should be at least one year . The assessment of other significant risks should generally be based on a period of two years. In the case of enterprises with longer market cycles or where enterprises are involved in major projects, it is recommended that a longer risk assessment period is used.

25.
It is preferable that inter-dependencies between individual risks are described; it is mandatory to do so, where an appropriate assessment of the risks is otherwise not possible.

26.
Risks may not be set off against opportunities.

27.
In order to allow a better assessment of risks, enterprises may also provide information about opportunities. This should not, however, lead to a distortion of the position of the group such that users of the financial report are no longer able to assess the risks.

28.
Risk management should be described in an appropriate manner.

29.
The risk management system should be presented in such a way as to enable users of the financial report to reach a better understanding of the risks affecting the group. The strategy, procedures and organisation of the risk management should be described.

30.
For the sake of clarity, information about risks should be presented in a self-contained section of the group management report. References to other parts of the financial statements or to other sections of the group management report may be appropriate if this does not impair the transparency of the information.

31.
Information about risks should be disclosed separately from disclosures relating to anticipated developments ("Prognosebericht").

32.
The information should be presented separately even though in reality there is a connection between the anticipated development of the group as required by § 315 (2) HGB and the risks affecting future developments as required by § 315 (1) 2nd Hs.. It may therefore be useful to refer in the risk report to the disclosures relating to anticipated developments.

33.
Risk reporting should be based on the position of the group at the time when the group management report is authorised for issue.

34.
Significant changes compared with the previous year should be disclosed where this is necessary for an assessment of the risks.

Effective date

35.
This Standard should be applied for the first time for financial years commencing after 31 December 2000. Earlier adoption is recommended.

Appendix: A. Example showing categorisation of risks

The following example shows how risks could be categorised for the purpose of risk reporting:

I. Business environment and industry risks	e. g.
	• political and legal developments
	• environmental catastrophes / war
	• risks relating to the economy
	• actions of competitors
	• market risks (volume/ price risks)
	• industry and product development
II. Strategic business risks	e. g.
	• product range
	• investments in other enterprises
	• capital expenditure
	• location
	• information management
III. Performance risks	e. g.
	• development
	• manufacturing
	• purchasing
	• sales
	• logistics
	• environmental policy
IV. Personnel risks	e. g.
	• employee recruitment
	• personnel development
	• fluctuation
	• key persons
V. Information technology risks	e. g.
	• data security
	• availability (risk of breakdown/ data loss)
VI. Financial risks	e. g.
	• liquidity
	• currency exchange rates
	• interest rates
	• market prices of securities
	• default risk
VII. Other risks	e. g.
	• organisational and management risks
	• legal risks
	• tax risks / tax field audits
	• health and safety risks
	• management and control systems

B. Basis for conclusions of the Draft Standard:

Following the introduction of the Law on Control and Transparency within Businesses (KonTraG) in May 1998, the management boards of public limited companies are now required to set up a monitoring system to identify at an early stage developments constituting a risk to the existence of the company (§91 (2) AktG). In the case of publicly traded companies, this monitoring system must be audited by the external auditors (§317 (4) HGB). At the same time new legislation was introduced expanding the disclosure requirements for (group) management reports, requiring the provision of information about the risks affecting future developments (§315(1) 2nd Hs. HGB and § 289 (1) 2nd Hs. HGB). This reporting requirement takes effect for the first time for financial years commencing after 31 December 1998. The legislation and the basis for conclusion of the new legislation did not, however, provide any specific details as to how the disclosures about risks should be reported. This draft Standard is intended to establish the procedures for the contents and structure of disclosures required by §315 (1) 2nd Hs. HGB (group management report). It is also recommended that the Standard is applied when reporting under §289 (1) 2nd Hs. HGB (individual company management report).

B1. Scope

The users of group management reports, in particular users participating in capital markets, need relevant and reliable information about the risks affecting future developments of a group (para. 2). In setting this objective, the Standard is following the concepts set out in the Frameworks of the IASC and the FASB. These frameworks both state that information is useful for users if it is understandable, relevant, reliable and comparable. Risk reporting in Germany based on this Standard will meet this requirement.

Information is deemed relevant if it influences the economic decisions of users by assisting them to assess past, present or future events or if it confirms or corrects assessments they have previously made. Information is reliable if it does not contain any significant errors, is not distorted and if users can be sure that the information credibly presents what it is intended to present.

In addition to the general objective of providing information about risks (para.2), the requirement to quantify risks is dependent amongst other things on the reliability of the models and the relevance of the information to the decision-making process (para.19).

The procedures for risk reporting have been intentionally formulated in a general conceptual way, since risks are always specific to each enterprise. In this way, each enterprise will be able to devise the most appropriate form of risk reporting for its own specific needs.

The Standard sets out the basic principles to be applied when parent companies are required to report on their risks as part of the group management reports in accordance with §315 HGB. It therefore applies to parent companies which are either limited liability companies (§290 HGB) or enterprises equivalent to such companies (§264a HGB), and to enterprises which are required to prepare consolidated financial statements in accordance with the German Disclosure Act. Banking and insurance groups also need to comply with further statutory requirements. The additional and specific procedures for risk reporting by groups from these industries are set out in separate Standards (GAS 5-10 and D-GAS 5-20).

The Standard should also be applied by enterprises which prepare consolidated financial statements in accordance with §292a HGB. Under §292a (2) no.3 HGB, enterprises can be exempted from preparing consolidated financial statements in accordance with the German Commercial Code if they already prepare consolidated financial statements in accordance with IAS or US GAAP and, to achieve equivalence, if they prepare a group management report. In GAS 1, the GASB indicates that the exempting group management report must conform with the 7th EC Directive, that it must be equivalent in its informational value to a group management report prepared in accordance with §315 HGB, and that the group management report should be set out in a self-contained section in the reporting documents.

Application for management reports prepared in accordance with §289(1) HGB is only recommended, since the legal mandate of the GASB set out in §342(1) no.1 HGB is directed at group financial reporting.

B2. Definitions

Risk is defined as the possibility of a future negative impact on the economic position of the group. The definition refers specifically to the economic position of the group and not to the "assets and liabilities, financial position and results from operations" since these items represent a concept in themselves which is not defined anywhere for the purposes of the group management report. The principle of proper financial reporting contained in §264 (2) HGB does not extend to the group management report. There is no reference in either §315 or §289 HGB to "assets and liabilities, financial position and results from operations".

In the additional explanatory paragraphs provided on the definition of risk, it is made clear that the economic position of a group is also dependent on the future success of the business. This demonstrates that we are not dealing with a dynamic rather than a static understanding of the term "risk". In addition, risks are also relevant if they can have an effect on the enterprise's expectations of anticipated developments as disclosed in the group management report (Prognosebericht). Definitions of specific categories of risk have not been included in the Standard, since each enterprise should apply the definitions which it uses internally to manage and control risks.

B3. Procedures

Main focus of risk reporting

The main focus of risk reporting should be on the specific risks facing the enterprise. The information provided should address industry and market risks, but it should nevertheless cover the individual risks facing an enterprise as specifically as possible and should not be overgeneralised. Risks which threaten the existence of the enterprise should be described as such.

The principle of materiality applies to all GASs, so that only material risks require to be disclosed.

Risks should be described and explained, i.e. it should be explained why a particular risk poses a material risk to the economic position of the group. The significance of the risks for the group should be made clear e.g. by describing the sequence or probability of occurrence and quantifying the effect of the risks.

Risk concentrations

Risks arising from concentrations must be disclosed because of the major effect they can have on the future economic position of a group. Risks relating to specific concentrations (dependence on patents, contracts, manufacturing processes) already need to be disclosed in prospectuses for enterprises listing securities on stock exchanges (cf. for example §20 (1) No.5 Stock Exchange Admission Regulations- BörsZulV- for securities listed on the Official Market). Enterprises listing on the Neuer Markt are required to disclose risks in their offering prospectus and to address amongst other things dependencies on specific markets, the termination of contracts and dependencies on industrial rights or individuals (see para. 4.1.16 of the Rules and Regulations of the Neuer Markt).

SOP 94-6 issued by the AICPA also recommends that US American enterprises disclose concentrations of risks (see Appendix E3).

Risk categories

Each enterprise should disclose the risks affecting it categorised on the same basis as that used internally for risk management purposes. The Standard does not set out any mandatory categorisation of risks since each enterprise will be faced with specific risks and will design its own risk management system. Instead, the Standard provides, as an appendix, an example of how risks could be categorised. It should be taken into account that the various risk categories may overlap.

Risk quantification

In line with the objective of risk reporting (para.2), the Standard requires that risks are quantified where three preconditions are met. Firstly, there must be reliable and recognised methods available to quantify risks. Secondly, it must be possible to provide quantified information in a way economically justified. Thirdly, quantification should always be relevant for the decision-making process of the user. Since quantification is usually dependent on the assumptions used, the Standard requires that the models and assumptions used are described and explained in a way that can be clearly understood.

At present, the requirement for quantification applies effectively only to financial risks. Quantitative information about risks can be presented in the form of sensitivities or using statistical methods (cash flow at risk, value at risk).

Risk reduction methods and management

As a general rule, risks should be disclosed after taking account of risk reduction measures. If these measures cannot compensate the risks with certainty, risks should be disclosed before taking account of such measures as well as the measures taken.

Where it is significant for an overall assessment of an enterprise's risk position, it may be appropriate to disclose risks even where they have been recognised in the financial statements i.e. by accruals or provisions. Once a risk has been recognised in the financial statements, it may no longer be a risk affecting future developments within the formal meaning of the law. From an investor's point of view, however, such risks need to be disclosed as part of a comprehensive and self-contained presentation of the risk position of the company.

Forecast period

As a general rule, reporting on risks should be based on an appropriate forecast period for each risk. At the same time, the reliability of the information is also an important factor. Due to the nature of the reliability of forecasts, the period over which the risk is being measured cannot be extended arbitrarily. In the case of risks threatening the existence of an enterprise the forecast must be particularly reliable. A relatively short forecast period of at least year after the balance sheet date is adequate. This corresponds to the period applied internationally for the *going concern* assumption. In the case of other significant risks, it is considered that two years is a manageable period. The use of longer forecast periods means that the reliability of the information is likely to be impaired.

Nevertheless, where the legal environment or external factors are in the process of change, or in the case of longer market cycles and complex major projects, the forecast period should be adjusted accordingly.

Opportunities

Opportunities relating to the possibility of a future positive impact on the economic situation of the group should not be set off against risks under any circumstances. Information should be provided first and foremost about the risks affecting future developments. It may, however, also be appropriate to discuss related opportunities.

Risk management

The description of the risk management system enables the user to gain a better understanding of the risk situation. In order to avoid an excess of detail in the group management report which would impair clarity, the Standard requires that the information shown about risk management should be presented in an appropriate manner. It is not necessary to comment on the effectiveness of the risk management system.

Self-contained presentation

Information about risks should be presented in a self-contained section of the group management report. Nevertheless, substantial repetition of points discussed in other parts of the consolidated financial statements or group management report should be avoided. - References to other parts of the consolidated financial statements do not detract from the general requirement of a self-contained presentation. References should be made where this can help to avoid unnecessary repetitions (e.g. financial risks which are disclosed in the notes to the consolidated financial statements) unless this impairs the transparency of the information.

Reporting on anticipated developments (“Prognosebericht”)

Although there is a clear link between the information presented on anticipated developments (“Prognosebericht”) and on the risks affecting those developments (“Risikobericht”), these two aspects should nevertheless be reported on separately. Although this Standard sets out the procedures for the contents of the risk report, it acknowledges that it may be appropriate to make references to the disclosures relating to anticipated developments (“Prognosebericht”).

Date of reference

Risk reporting should be based on the position of the group at the time when the group financial reporting are prepared and not at the balance sheet date itself. Information should therefore be provided about risks arising subsequent to the balance sheet date and up to the date when the consolidated financial report is prepared. This includes both adjusting and non-adjusting post balance sheet events. This reporting requirement is based on § 289 (2) no. 1 and § 315 (2) no. 1 HGB. Changes compared with the previous year should be disclosed where this is necessary for a proper understanding of the risks.

C. Compliance with existing legislation and German Accounting Standards

C1.
In conjunction with the Law on Control and Transparency within Businesses (KonTraG) the provisions relating to management reports and group management reports contained in § 289 (1) 2nd Hs. and § 315 (1) 2nd Hs. HGB respectively were extended by a requirement to report on the risks affecting future developments. The requirement to report on risks in the (group) management report is therefore based on current legislation.

C2.
This Standard sets out the general procedures for reporting on risks and is compatible with the industry specific Standards on Risk Reporting by Financial Institutions and Financial Service Institutions (GAS 5-10) and by Insurance Enterprise (D-GAS 5-20) .

D. Comparison with IAS

General

D1.
Under IAS there is no equivalent to the (group) management report. IAS 1.8, however, encourages enterprises to present, outside the financial statements, a *financial review by management* which describes and explains the main features of the enterprise's financial performance and financial position as well as the principal uncertainties it faces. Very little specific guidance is given, however, on the actual contents of such a review. Other individual IAS also require the disclosure of various risks. This is generally restricted to financial risks.

D2.
IAS 1. 8 contains the following recommendation: a *financial review* may include information about the main factors and influences determining performance, including changes in the environment in which the enterprise operates and the enterprise's response to those changes and its risk management policies.

D3.
In principle, GAS 5 is compatible with IAS 1.8. Both standards require that information is provided about risk management policies, significant risks influencing performance and the measures taken by enterprises in response to risks. A group management report and a *financial review* differ, however, in some fundamental aspects. In contrast to a *financial review* under IAS 1.8, a group management report is a mandatory component of financial reporting. For this reason, this Standard requires the disclosure of information about risks rather than recommending it. Furthermore, the information about risks included in the group management report must be audited by the statutory auditor and reported on in the audit report and opinion. The contents of a *financial review* do not require to be audited. In addition, the procedures for risk reporting set out in this Standard are more specific and more detailed.

Financial risks

D4.
Individual IAS contain disclosure requirements or recommendations for financial risks which relate specifically to the financial statements or the notes to the financial statements. For example, IAS 32.43A requires that enterprises describe their financial risk management objectives and policies, including their policy for hedging each major type of transaction. The disclosures may include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the instruments and their relative significance to the enterprise (IAS 32.44). Determination of the level of detail to be disclosed about particular financial instruments is a matter for the exercise of judgement taking into account the relative significance of those instruments (IAS 32.45).

D5.
IAS 32.56 requires that an enterprise should disclose information, for each class of financial asset and financial liability, about its exposure to interest rate risk, including contractual repricing or maturity dates and effective interest rates.

D6.
IAS 32.66 requires that for each financial asset and financial liability, an enterprise should disclose information about its exposure to credit risk, including the amount that best represents its maximum credit risk exposure at the balance sheet date and significant concentrations of credit risk.

D7.
When an enterprise has accounted for a financial instrument as a hedge of risks associated with anticipated future transactions, it should disclose (IAS 32.91)

- a description of the anticipated transactions, including the period of time until they are expected to occur
- a description of the hedging instruments
- the amount of any deferred or unrecognised gains or losses and
- the expected timing of recognition as income or expense

D8.
IAS 21.47 encourages the disclosure of an enterprise's foreign currency risk management policy.

Provisions

D9.
IAS 37 requires that information is provided about risks for which provisions have been recognised in the balance sheet. For each class of provision, an enterprise should provide a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits as well as an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions forming the basis for the computation of the provision (IAS 37.84-89).

D10.
Unless the possibility of any outflow in settlement is remote, an enterprise should disclose, for each class of contingent liability at the balance sheet date, a brief description of the nature of the contingent liability, an estimate of its financial effect and an indication of the uncertainties relating to the amount or the timing of the outflow (IAS 37.86).

D11.
Where, in extremely rare cases, disclosure of some or all of the information can be expected to prejudice seriously the position of an enterprise in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset, IAS 37.92 permits the enterprise not to disclose the information. In such cases, the enterprise should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

E. Comparison with US GAAP

E1.
<u>General</u>

Under US GAAP there is no exact equivalent to the management report. Nevertheless, there are also requirements under US GAAP to disclose information about risks. Enterprises which are subject to SEC regulations, are required to make additional disclosures.

E2.
<u>Loss contingencies</u>

Future events, where the probability of occurrence is *reasonably possible* (i.e. in the range between *probable* and *remote)*, may require disclosure under FAS 5.10 as a *loss contingency* or, under FAS 5.17, as a *gain contingency*. Examples of loss contingencies requiring disclosure are the threat of expropriation or pending or threatened litigation. FAS 5.14 states that general or unspecified risks do not require to be disclosed.

E3.
<u>Disclosure of significant estimates and concentrations</u>

SOP 94-6, para. 13 requires disclosure of the use of estimates for measuring assets, liabilities and the disclosure of loss contingencies, if it is at least *reasonably possible* that the estimate of the effect on the financial statements of a condition, situation or set of circumstances that existed at the date of the financial statements will change in the near term (within one year) due to one or more future confirming events.

If enterprises use risk reduction techniques to mitigate losses or uncertainty and therefore determine that the criteria requiring disclosure are not met, then SOP 94-6, para. 15 encourages but does not require disclosure of the nature of the uncertainty and of the risk reduction techniques.

E4.
In addition SOP 94-6, para. 21 requires disclosure of concentrations to which an enterprise is exposed, if all of the following criteria are met:

- the concentration exists at the balance sheet date.
- the concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- it is at least reasonably possible that the events that could cause the severe impact will occur in the near term (within one year).

Examples given are:
- concentrations in the volume of business transacted with a particular customer, supplier etc. For the purposes of the SOP, it is always considered at least reasonably possible that any customer etc. will be lost in the near term.
- concentrations in the revenue from particular products, services etc.
- concentrations in the available sources of supply of materials, labour or services, or of licenses etc. used in the enterprise’s operations.

- concentrations in the markets or geographical area in which an enterprise conducts its operations. Here also it is always considered at least reasonably possible that operations located outside an enterprise's home will be disrupted in the near term.

SOP 94-6 does not deal with risks relating to financial instruments.

E5.
Risks relating to financial instruments

FAS 133.44 et seq. requires, amongst other things, disclosure of the following:

- the objectives for holding or issuing such instruments
- the risk management policy
- qualitative disclosures about derivative financial instruments and quantitative disclosures for non-derivative instruments which are related to derivative instruments, are encouraged but not required.
- additional disclosures depending on the hedging method.

E6.
Going Concern

The "going concern" issue is dealt with in the standards on auditing rather than in the accounting standards (SAS 59, AICPA, AU 341). An unqualified audit opinion can be issued even where there is doubt about the continued existence of an enterprise, as long as the enterprise makes adequate disclosures on this matter. Under SAS 59 the disclosures can relate for example to:

- conditions or events giving rise to the assessment of the substantial doubt about the enterprise's ability to continue as going concern.
- the possible effects of such conditions or events.
- management's strategy to mitigate these conditions or events.
- the possible discontinuance of operations.

E7.
SEC rules

Foreign enterprises, who are subject to SEC rules, must make certain disclosures about risks in Form 20-F. Mandatory disclosures about risks are included in items 3D, 5D and 11 (amongst others) of the Form 20-F version valid for years commencing after 30 September 2000.

Domestic enterprises, who are subject to SEC rules, are required to make certain disclosures about risks in Form 10-K. Mandatory disclosures about risks are contained in items 7 and 7a (amongst others).

E8.

Risk factors (Form 20-F item 3D)

This section should be used to disclose individual risks or industry specific risk factors, which make the securities speculative or very risky. It is recommended that the risk factors are listed according to priority. This section serves to provide a summary of the risks, which are disclosed in other parts of Form 20-F in a more detailed form.

E9.

Operating and Financial Review and Prospects – Trend Information (Form 20-F item 5D)

This report serves amongst other things to present the management's assessments of factors and developments, which are expected to have a major impact on the future financial position and performance of an enterprise. The focus should be on events and uncertainties identified by management, especially where the information included in the financial statements may not necessarily give an appropriate indication of the future financial position and performance of the enterprise. In this context, it should be noted that disclosure only needs to be made of information relating to the future where such information is already known i.e. labour or materials price increases which have already been announced. The disclosure of other information relating to the future is encouraged but not required.

E10.

Quantitative and qualitative disclosures about market risks (Form 20-F item 11)

This section is used to provide quantitative and qualitative disclosures about financial risks such as interest and currency rate risks. Qualitative disclosures should include, amongst other things, a description of objectives, strategies and instruments used to mitigate the related financial risks.

E11.

Disclosure requirements in Form 10-K

Domestic (US) enterprises, who are subject to SEC rules, are required to use Form 10-K.7a to provide *Quantitative and qualitative disclosures about market risks* (cf. E 10 for the corresponding disclosure requirements to be made in Form 20-F item 11). The reporting requirement for risks are derived in particular from Form 10-K item 7 i.e. the "Management's Discussion and Analysis of Financial Condition and Results of Operation" (MD&A). The disclosures required in this document correspond to a large extent to those required in the *Operating and Financial Review and Prospects – Trend Information* (Form 20-F item 5D), so that it is possible to refer to the disclosures made there (see E9.).

F. Compliance with EC Directives

F1.
Although the 4th and 7th EC Directives do not contain any explicit reference to disclosures about risks affecting future developments, the principles contained in this Standard do not conflict with any EU norms. Article 36 of the 7th EC Directive corresponds to the previous wording of § 315 (1) HGB (old), i.e. the group management report should at least present the course of business and the state of the group so that a true and fair view is presented. The requirement to provide information about risks can be interpreted as a specification of a requirement which already existed. Similarly Article 46 of the 4th EC Directive corresponds to the previous wording of § 289 (1) HGB (old).

F2.
Announcements by the Commission concerning the reform of EC Directives and the proposal to incorporate fair value accounting for specific financial instruments into the EC Directives suggest that a corresponding EU norm will be established for risk reporting, at least for financial risks. Accordingly Article 46a of the EU Commission proposal to change the 4th and 7th EC Directives in relation to fair value accounting for specific financial instruments, includes a requirement for the group management report to disclose information about the risk management objectives and policies relating to financial instruments.