Building a Better MD&A
RISK DISCLOSURE
March 2008
The Canadian Performance Reporting Board (CPRB) is responsible for providing vision and leadership to the work of the Canadian Institute of Chartered Accountants (CICA) in advancing the measurement and reporting of organizational performance other than financial statement reporting. In fulfilling its mandate, the CPRB publishes recommended practices, guidance documents, and awareness raising reports.

Regulators and investors have expressed the need for improved disclosures about risk. This publication is therefore intended to raise awareness and provide assistance to MD&A preparers in presenting risk disclosures.

This guide expands upon the recommended practices included within the CICA’s Management’s Discussion and Analysis - Guidance on Preparation and Disclosure. It addresses how to decide which risks should be disclosed, what to disclose about those risks, and questions directors may wish to consider when considering the adequacy and completeness of risk disclosures.

The CPRB welcomes comments about this guidance. They should be addressed to:

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1. INTRODUCTION

Investors want to assess a company’s future cash flows and financial condition. They want disclosures about uncertainties – in the industry and within the company - that could undermine this assessment.

Good risk disclosures assist in enabling investors to evaluate the quality and prospective volatility of company earnings and cash flows. Good risk disclosures also enable investors to assess a company’s resiliency – its ability to respond to risk events.

The CICA’s Management’s Discussion & Analysis - Guidance on Preparation and Disclosure (MD&A Guidance) recommends that a company

“disclose its principal risks and describe related risk management systems to enable MD&A report readers to understand and evaluate the company’s risks and its decisions regarding the management of such risks”.

Securities regulators require that the MD&A:

“discuss important trends and risks that have affected the financial statements, and trends and risks that are reasonably likely to affect them in the future.”

The challenge for companies is how best to provide such disclosures in a way that is clear and sufficient - focusing on information that is material to investors, while not exhaustive or overwhelming in detail.

This guide provides practical tips to help companies decide what risk disclosures to make in the MD&A.

This publication is structured as follows: Part 2 provides practical guidance on deciding what risks to disclose; Part 3 provides guidance on what to disclose about risks; Part 4 provides guidance on ensuring the reliability and timeliness of risk disclosures in the MD&A.

Examples of recent MD&A risk disclosures can be found at the CICA’s Performance Reporting Resource Centre at www.cica.ca/cpr.

2 National Instrument 51-102F1, Part 1(a). The regulators also require specific MD&A disclosures as set out in Part 2, Items 1.2 and 1.4.
2. SELECT THE RISKS TO DISCLOSE

2.1 WHERE TO START

Begin by reviewing the six general disclosure principles for MD&As.³

1. *Through the eyes of management:* Investors do not want a boilerplate listing of every conceivable risk; instead, they want to know about those risks and uncertainties that are important to senior management.

2. *Integration with financial statements:* MD&A risk disclosures include information about risk and risk management that is not revealed in financial statements as well as providing additional discussion about risks that are mentioned in financial statement notes.

3. *Completeness and materiality:* Investors want a discussion of material risks; completeness needs to be assessed in terms of materiality. What would influence a reasonable investor in his/her decision to invest or continue to invest in the company?

4. *Forward-looking orientation:* Risk disclosures are inherently forward-looking; risks, if they materialize, can impact future cash flows, financial results and financial condition.

5. *Strategic perspective:* What is the company’s strategy for managing principal business risks? How are uncertainties addressed in the company’s strategic plan?

6. *Usefulness:* Investors appreciate MD&A risk disclosures that are written in plain language and provide comparable and consistent information over reporting periods.

It is neither necessary nor useful to provide disclosures about every risk and uncertainty that a company faces. It is important, however, for MD&A preparers first to identify a complete set of risks and then consider those that merit disclosure.

For annual MD&As, begin by reviewing information sources that will help to identify the key risks most likely to be important to investors. If a company has more than one reportable business segment, the review should be carried out by segment.

While it is essential not to overlook the financial statements and securities regulators’ disclosure requirements, other sources include:

- **Strategic Statements and Plans:** Consider business strategy and goals for the year as communicated internally and externally by management. Identify those internal and external risks that were taken into account in development of the strategy and goals.

- **Enterprise Risk Management Reports:** For those companies that have implemented an enterprise risk management system, consider the risks identified therein.

- **Board Minutes:** Review board agendas, minutes and submissions to identify business risks considered by the board in their oversight of strategic planning and risk management.

- **Competitors’ Disclosures:** Review other companies’ risk disclosures, especially those of primary competitors.

- **Award Winning Disclosures:** Consider the risk disclosures of winners of the CICA Corporate Reporting Awards.

- **Analysts’ Reports:** Look at analysts’ reports on your company or on competitors.

- **Conference or Investor Presentations:** Review questions and discussions at conference or investor presentations about your company or any presentations by companies in the same industry.

- **Prior Period MD&A Disclosures:** Review risk disclosures made in prior period annual and interim MD&As to assess the need for updating.

- **Press Releases:** Review press releases to identify any material risk factors related to forward-looking information contained therein.⁴

**Financial Statements and Notes**

Since MD&As complement and supplement the financial statements, it is important to review the financial statements to identify any underlying risk issues. Accounting standards call for certain risk disclosures to be provided in notes to financial statements.

Consider the need for any risk disclosures, beyond those in financial statement notes, which would assist investors in understanding the nature and potential impact of risks on future cash flows, financial condition and operating results.

**Securities Regulators’ Requirements**

In addition to reviewing the above sources, it is essential to review securities regulators’ requirements regarding risk disclosures:

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Canadian Securities Administrators (CSA) require risk disclosures in both a company’s MD&A and its Annual Information Form (AIF).5

Securities regulators require that MD&As discuss important risks that have affected the financial statements and that are reasonably likely to affect them in the future.6

Furthermore, securities regulators have specified certain additional MD&A risk disclosures:

- risks or uncertainties that are reasonably expected to materially impact future results of operations;7
- liquidity risks associated with financial instruments;8
- risks associated with off-balance sheet items;9
- risks associated with financial instruments and other instruments;10 and
- risks associated with any weaknesses in the design of an issuer’s internal control over financial reporting.11

In reviewing the above risks and uncertainties that need to be disclosed, it is important to consider risks that may impact financial flexibility, such as risk of failure to meet covenants in bank credit facilities or risk of non-renewal of expiring facilities.

In addition to MD&A risk disclosure requirements, securities regulators require AIF disclosure of risk factors relating to the company and its business, such as:

- cash flow and liquidity problems, if any;
- experience of management;
- the general risks inherent in the business carried on by the company;
- environmental and health risks;
- reliance on key personnel;
- regulatory constraints;
- economic or political conditions and financial history; and
- any other matter that would be likely to influence an investor’s decision to purchase securities of the company.

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5 Venture issuers are not required to file an AIF.
6 CSA Form 51-102F1 Management’s Discussion & Analysis, Part 1 (a)
7 Ibid, Part 2, 1.4(g).
8 Ibid, Part 2, 1.6(d).
9 Ibid, Part 2, 1.8.
10 Ibid, Part 2, 1.14(b).
11 CSA Staff Notice 52-316 Certification of Design of Internal Control Over Financial Reporting (not applicable to venture issuers).
12 Venture issuers are not required to file an AIF – CSA NI 51-102 Part 6.1.
Securities regulators also require AIF disclosure of any factors or considerations identified by approved rating organizations that give rise to unusual risks associated with the securities of the company.\(^{13}\)

As AIFs are often not distributed to investors, report preparers may choose to include AIF risk disclosures, or portions thereof, in the MD&A for the benefit of investors.

**Regulatory Continuous Disclosure Review Reports**

In addition to reviewing the above regulatory requirements, it is important to review recent CSA reports and staff notices that summarize recurring MD&A disclosure deficiencies.

Securities regulators’ reviews of MD&As have frequently identified risk disclosures as an area for improvement for the majority of issuers. For example, securities regulators in Ontario have noted that “analysis of risks and uncertainties continues to be a weak area” - regulations require in the MD&A “an analysis of how material risks and uncertainties may affect the business, not just a description of the risks”\(^{14}\)

> “Many issuers either did not disclose risks at all, or simply provided a list of risks and uncertainties that failed to include an in-depth analysis of how these risks may impact their financial condition, changes in financial condition and results of operation (sic).”\(^{15}\)

A specific category of risk to which regulators are paying closer attention in their continuous disclosure reviews is environmental risks\(^{16/17}\).

It is also important to review any comment letters received from regulators.

### 2.2 Deciding Which Risks to Disclose

Once a company has developed a list of risks to be considered for disclosure, the next step is to select from the list those risks whose disclosure is most likely to be important to investors. This assessment should be carried out by reportable business segment.

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13 Ibid, Part 2, 7.3(e).
15 OSC Staff Notice 51-706, Report of Staff’s Review of MD&As, December 16, 2005, Part 2, B.
Industry-Specific Risks

Should risks common to an industry be disclosed or is it safe to assume that investors in that industry understand such risks?

Report preparers need to assess whether investors are likely to be aware of risks common to the industry sector in question. If one concludes that the answer is no, then disclosures would be called for. If the answer is yes, there will still be a reason to make disclosures if those risks are material. Further, report preparers may want to give attention to whether the company has adopted risk management strategies that differ from those of its competitors.

Potential Impact

Report preparers need to consider the potential impact on financial condition, results and cash flows if the risk were to materialize. They need to consider whether disclosure of the risk would influence a reasonable investor in his or her decision to invest or continue to invest in the company.

If management concludes that the financial impact of a given risk would be low, regardless of the likelihood that it will materialize, there would be little reason to disclose the risk. In making this determination, however, management should consider whether the impact might reasonably be expected to grow over time (possibly a few years ahead), in which case early disclosure of the risk might be important to long-term investors. This would be particularly relevant where the company is in an industry with a long business cycle (e.g. pharmaceuticals, oil and gas, mining).

If, on the other hand, management concludes that the financial impact of a given risk would likely be high, there is reason to provide disclosure about that risk and any related risk mitigation steps the company has taken. For those risks which involve high impact, even if the likelihood of their materializing is currently considered low, report preparers need to consider whether these risks would likely influence a reasonable investor in his/her decision to invest or continue to invest in the company and make disclosures accordingly.

Some companies may feel obliged for legal reasons to provide a comprehensive list of all risks, regardless of management’s assessment of their potential impact and likelihood of materialization. In such cases, management can assist readers of MD&As by delineating those risks that, in its assessment, are most likely to be material to investor decision-making.

2.3 INTERIM MD&A

It is reasonable to assume that investors have read the annual MD&A and previous interim MD&As; therefore, it is only necessary to update risk disclosures if changes have occurred since the last MD&A.

Some companies choose, however, to restate key risk information disclosed in the previous annual MD&A as well as any changes in the latest reporting period.
3.1 CONTENT OF RISK DISCLOSURES

It is important to provide investors not only with an explanation of the nature of each risk and the likelihood that it will materialize but also an indication of how its materialization could affect the company’s business, its financial condition, cash flows and results of operations. Investors often find sensitivity analyses helpful in understanding the potential impact of risks. Analyses of the potential impact of risks should be accompanied by appropriate cautions to the reader and explanations of the relevant underlying assumptions used and the potential impact of significant changes to such assumptions.

Investors are interested too in understanding management’s risk tolerance. They want to know about actions or strategies, if any, that a company has taken or implemented to mitigate identified risks. This information is often helpful to investors in differentiating between companies in the same industry.

“Enterprises in the same industry, facing similar risks, will often choose different risk management actions because different managements have different risk strategies, objectives and tolerances. Investors need to be aware of these differences.”18

Management may hesitate to provide certain disclosures about risk management strategy fearing they might reveal confidential information which might jeopardize competitiveness. Anecdotal evidence suggests that companies in any given industry sector are often aware of strategic, operational and financial information about their competitors, derived from commercial and market sources other than formal filings and reporting. With this in mind, management (and the board of directors) therefore need to examine the appropriateness of omitting information from MD&As which might be material to investor decision-making.

Investors are interested in knowing the organizational and financial resources that the company assigns to the identification and management of risk. For example, what is the nature of the involvement of the board of directors, committees of the board and senior executive employees in the area of risk identification and management? Has the company instituted a system for enterprise risk management? What is the nature and reliability of the underlying information and control systems used in monitoring risks and the effectiveness of risk management strategies?

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When a previously reported risk is no longer considered material for disclosure, an explanation of why this is so might be helpful to investors.

3.2 WHERE TO PLACE RISK DISCLOSURES

Many companies choose to present a separate risk section within their MD&As to summarize in one location the disclosures about those risks that management has determined are most important to investors for investment decision-making.

In addition, some companies intersperse a discussion of risk within various other sections of the MD&A, to reflect the linkages between risk and other aspects of the company’s business, such as corporate strategy, capital resources, liquidity, key performance drivers and outlook.

Risks that have been disclosed in the MD&A need not be repeated in the AIF; instead, reporting issuers can satisfy their regulatory requirements for AIF reporting by providing a reference in the AIF to the risk disclosures in the MD&A.19 The corollary is not true; that is, MD&A risk disclosure requirements cannot be satisfied by referencing AIF risk disclosures.

19 CSA Form 51-102F2, Annual Information Form Part 1(f).
Risk disclosures are seen by investors as an important element of MD&As. Investors may interpret the quality and transparency of risk disclosures as a reflection of the quality of management and corporate governance.

Boards of directors are required to approve MD&As before they are filed with regulators. In view of their responsibilities for oversight of strategy and risk management and the information they receive in the normal course of their directorship duties, boards of directors are well positioned to assess the adequacy of MD&A risk disclosures.

The following questions are presented as potential aids to members of boards of directors and board committees in fulfilling their responsibilities related to risk disclosures.

1. Are the MD&A risk disclosures consistent with the information that management has previously presented and reviewed with us in the course of our normal directorship duties?

2. Do the MD&A risk disclosures comply with regulatory disclosure requirements?

3. Are there adequate information systems and controls to support reliable and timely risk and risk management disclosures?

4. Are we satisfied with management’s explanation of how it has determined what risk disclosures to provide in the MD&A and do the resulting disclosures address principal business risks, their potential impact, and mitigation strategies?

5. Is there any risk information that management has omitted from the MD&A due to competitive or other concerns and if so, are we satisfied with omitting this information?

6. What feedback, if any, has been received from institutional or other significant investors or their proxies about the adequacy of the company’s risk disclosures?

7. Has the company received any comments from regulators on the adequacy of its risk disclosures?

8. What comments have legal counsel provided regarding risk disclosures and how have these comments been addressed?

9. What comments, if any, do the external auditors have about the MD&A risk disclosures?

10. Have the MD&A risk disclosures been written in clear, plain language?
360.1 Risk and risk-taking pervade all elements of business activity and hence all elements of the MD&A disclosure framework. Risk disclosures are essential to enable readers to see the company through the eyes of management.

360.2 Recommended Practice: A company should disclose its principal risks and describe related risk management systems to enable MD&A report readers to understand and evaluate the company’s risks and its decisions regarding the management of such risks. Such disclosure should include:

- the principal risks and uncertainties facing the company and its core businesses and segments, as appropriate;
- the strategies and processes employed for managing these risks; and
- the potential specific impact of these risks on results and capabilities, including capital resources and liquidity.

360.2.1 This recommended practice emphasizes the need to be specific in disclosing risks and their potential impact as well as the importance of disclosures about risk management, strategies and processes. Regardless of corporate governance disclosure and annual information form requirements, management disclosures about risks and risk management should be included within the MD&A so that readers can understand the business and appreciate how risk impacts the various elements of the disclosure framework and can affect future prospects. The risk disclosures in the MD&A should be consistent with the risks and risk management systems identified and dealt with by the board of directors.

360.2.2 Risk is defined as “the possibility that an event, action or circumstance will adversely affect an organization’s ability to achieve its business objectives”. This encompasses exposure to negative consequences (“downside”) and the possibility that positive consequences (“opportunities”) will be missed. There is uncertainty about both the likelihood of occurrence and the consequences of a risk.
360.2.3 Specific disclosures about risks present a challenge to most companies. While different industries and companies use different risk models or approaches for identifying, managing and discussing risk, all companies face and should disclose both strategic and operational (including financial) risks.

360.2.4 Whatever the model or approach used, risk disclosures should be as specific as possible. They should be not only summarized in a separate risk section, but also provided in discussions of the appropriate elements of the disclosure framework – that is, strategy, key performance drivers, capability (resources, systems and extended enterprise arrangements), and/or performance results. In attempting to manage certain risks, companies may use innovative strategies that can, in turn, give rise to new risks that should be clearly outlined and evaluated for MD&A readers. Therefore, risk disclosure encompasses significantly more than presenting a boilerplate listing of risks.

360.2.5 Quantitative information on risks and their potential impacts on future prospects of the business should be presented, along with qualitative information. In particular, it is useful to provide specific quantitative information about the potential variability of results depending on the outcome of the disclosed risks.

360.3 Recommended Practice: There should be continuity and consistency from one period to another regarding risk disclosures and how the risks impact on results.

360.3.1 This recommended practice adds a new dimension to existing regulatory requirements. Consistent with Principle 6, Usefulness, and specifically paragraph 260.5, if risks should change significantly from one period to another, there is a need to explain the removal or addition of specific risk disclosures.