REGULATORY SUPPLY AND MARKET DEMAND OF RISK MANAGEMENT: MATCH OR CLASH?

Christoph Van der Elst, Erik Vermeulen*

Abstract

The paper raises questions as to whether the new risk governance requirements will be able to match the prerequisites for more balanced risk governance as part of the decision making process while fostering business entrepreneurship. Further, to comfort the market it will be necessary to report in accordance with market expectations adequate information about the financial and non-financial risks the companies is coping. Both questions will be addressed in this paper.

Keywords: risk management, supply, internal control, requirement, monitoring, disclosure, board of directors, corporate law, TIAA-CREF

* Christoph Van der Elst is Professor of Business Law and Economics, Tilburg Law School and Ghent University, visiting Professor, Torino University (CLEI) and College of Europe (Bruges); Erik Vermeulen is Professor of Business Law, Tilburg Law School, Professor of Financial Market Regulation, Tilburg Law & Economics Center, Visiting Professor, Faculty of Law, Kyushu University, and Vice-President Corporate Legal Department of Philips (Corporate and Financial Law Group), The Netherlands.

Introduction

During the last era risk management became embedded in corporate law and corporate governance. The entrenchment followed the development of interpreting the duties of the board of directors and management of large (listed) companies. For a long period there were generally no legal requirements that established any particular norm for board members except to run the corporation in the best way they see fit and to take appropriate risks to develop and grow the business. Many companies’ acts and corporate governance codes refined the general requirement of boards of directors to manage the company and went on to extend other obligations, such as the requirement to establish a system of internal control and risk management system and to report on the characteristics and/or the effectiveness of their system of internal control accompanied with an auditors report thereon.

These new regulations were further strengthened and ad hoc legislative and regulatory reforms were launched after major collapses and corporate debacles during the last decade. Quick scans and analysis of the major cases showed that the levels of risk taking were not appropriately identified and constrained by boards of directors and many risks, especially in the financial sector, were seriously underestimated. It followed that the reporting formats were blurred or ineffective, that filters in the reporting lines delayed appropriate and corrective actions and distorted the sharing of risk related information with senior management and in particular the board of directors. In combination with the limited availability of the (non-executive) members of the board of directors, the complexity of many risk management issues related to complicated financial and other products and the scarce resources of relevant skills and expertise in the many different domains in which many companies operate, many questions were never raised and serious problems were only discovered days before the collapse of some major (financial) firms. The follow-up reforms to mitigate new corporate and economic debacles were rushed trough parliaments and governments and “one-size-fits-all” mandatory formal rulebooks were developed. Companies experienced the pressure from creditors, agencies and even investors to engage in risk reduction policies.
It raises questions as to whether the new risk governance requirements will be able to match the prerequisites for more balanced risk governance as part of the decision making process while fostering business entrepreneurship. Further, to comfort the market it will be necessary to report in accordance with market expectations adequate information about the financial and non-financial risks internal and external risks the companies is coping. Both questions will be addressed in the next sections of this paper.

Section 1 looks at the major developments of risk management of “regular” businesses in a number of European Member States and the United States.

Section 2 discusses the market demands for appropriate risk management systems and transparency of the risk management programs.

Section 3 assesses the one-size-fits-all attitude of regulators and argues that risk management systems should offer flexibility.

1. Supply of regulatory risk management in corporate law and corporate governance

In the United States the board’s oversight responsibility for the preparation of the corporation’s financial statements encompasses the corporation’s compliance with the requirement to keep corporate records and to provide financial statements to shareholders. Subsection 8.01(c)(6) expands the board’s oversight responsibility to having internal controls in place in order to provide reasonable assurance regarding (1) the reliability of financial reporting, (2) the effectiveness and efficiency of operations, and (3) the compliance with applicable laws and regulations. In accordance with the 1977 Foreign Corrupt Practices Act (FCPA), the US Securities and Exchange Commission (SEC) requires reporting companies to keep books, records, and accounts and to maintain internal control reviews in order to control management activities.

Around that period securities regulation started to emphasize the importance of adequate disclosure of management’s risk assessments. In 1982, Item 303 on Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) was added to Regulation S-K. The SEC had adopted the present form of the disclosure requirements for MD&A as early as 1980. The management report must report on the material events and uncertainties that can cause financial information to be less indicative of future results and condition. Hence, these reporting requirements compel management to assess all risks and threats companies may encounter and to address the issues in a reliable management’s discussion and analysis statement. “The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.” In particular, management must address uncertainties and events that can influence liquidity, capital resources, results of operations, off-balance sheet arrangements, and especially contractual relationships. The SEC has modernized the disclosure requirements in the annual and quarterly reports of issuers in 2005 and aligned the risk factor section with the prospectus requirements. The report must contain a discussion of the most significant risk factors, similar to the risk factors referred to in item 503 (c) of Regulation S-K.

Since 2004 the European Transparency Directive requires that issuers’ annual and interim reports include “a description of the principal risks and uncertainties that [it] face[s]”. The requirement to disclose the principal risks and uncertainties obliges companies to install at least a risk and uncertainty identification system. Similar requirements can be found in the Prospectus Directive 2003/71/EC and Commission Regulation 809/2004 that obliges companies to include risk factors in the prospectus. The list of risk factors must comprise company-specific risks and/or risks related to the

---

42 Model Business Corporation Act (MBCA) section 16.01 and 16.20
43 Committee on Corporate Laws of the American Bar Association, Model business corporation act annotated: official text with official comments and statutory cross-references, revised through 2005, Chapter 8, p. 8-6, see official comments.
44 See <http://www.sec.gov/rules/interp/33-8350.htm>.
45 Title 17 (Commodity and Securities Exchanges), Part 229 (Regulation S-K), Item 303 (“Management’s discussion and analysis of financial condition and results of operations”) of the Code of Federal Regulations, § 229.303; see “Instructions to paragraph 303(a),” under no. 3. The cited reporting requirement existed before SOX was developed (see 17CFR229.303, Code of Federal Regulations, Title 17, Volume 2, Revised as of April 1, 2002, From the U.S. Government Printing Office via GPO Access), and it did not change after the enactment of SOX (see 47 FR 11401, Mar. 16, 1982, as amended at 47 FR 20983, July 9, 2002; 47 FR 54768, Dec. 6, 1982; 52 FR 30919, Aug. 18, 1987; 68 FR 5999, Feb. 5, 2003; 73 FR 958, Jan. 4, 2008).
46 The analysis for Europe and its member states is largely based on C. Van der Elst, The Risks of Corporate Legal Principles of Risk Management, ECGI working paper nr. 160/2010, 2010, 33 p. available at http://ssrn.com/abstract=1623526.
47 Article 4, paragraph 2, subpart c and article 5, paragraph 4 Directive 2004/109/EG of the European Parliament and the Council of 15 December 2004 on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market, OJ L 390, p. 38.
securities issued that are material for taking investment decisions.\textsuperscript{48}

The revised Fourth and Seventh company law directives require an annual corporate governance statement from listed entities. This statement must contain 'a description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process'.\textsuperscript{49} On the consolidated level, 'a description of the main features of the group’s internal control and risk management systems in relation to the process for preparing consolidated accounts’ must be provided.\textsuperscript{50}

The statement can be integrated in the management report or be published as a separate report. There are some legal differences between the two publication methods but in both cases the auditor’s opinion is required to cover the consistency of the main features of the company’s internal control and risk management systems in relation to the financial reporting process. As a minimum, the auditor will have to control the availability in the corporate governance statement of the description of the main features of the system in relation to the financial reporting process and issue a consistency opinion.

The Directive did not provide any guidance as to the level of work required nor did it oblige the auditor to start a forensic audit.\textsuperscript{51}

In the 2006 directive on statutory audits it is stipulated that public-interest entities must establish an audit committee (or alternative body) to monitor the financial reporting process and to monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems.\textsuperscript{52} The statutory auditor must also 'report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.'\textsuperscript{53} In its Statement on Risk Management and Internal Control, the European Corporate Governance Forum confirmed that company boards are responsible for monitoring the effectiveness of internal control systems but pleaded against a legal obligation for boards to certify the effectiveness of internal controls.\textsuperscript{54} The European Commission’s recommendation on independent directors and committees of the board recommends the audit committee to assist the board in its task to review the internal control and risk management systems and the effectiveness of the external audit process and to ensure the effectiveness of the internal audit function.\textsuperscript{55}

The different UK Codes emphasized that the board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets. The system should not only cover financial controls but also operational and compliance controls, as well as risk management. The Institute of Chartered Accountants of England and Wales provided further guidance regarding internal control and risk management via the Turnbull report in 1999. The board of directors is responsible for maintaining a sound system of internal control and must ensure that the system is effective in managing risks in a by the board approved manner.\textsuperscript{56}

Management is responsible for implementing the board’s policies on risk and control. Management should also provide the board with a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks.\textsuperscript{57} The board itself should make a public statement on internal control and it should therefore undertake an annual assessment that should consider the changes in the nature and extent of significant risks, as well as the company’s ability to respond to changes.

Further, it is the board’s responsibility to annually review ‘the effectiveness of the group’s system of internal controls and should report to shareholders that they have done so. The review should cover all

\textsuperscript{48} Article 2 under (3), Commission Regulation (EC) No. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, OJ L 149, p. 1.

\textsuperscript{49} Article 1, paragraph 7, subpart c, Directive 2006/46/EC of 14 June 2006 of the European Parliament and of the Council amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, OJ L 224 of 16 August 2006, p. 1.

\textsuperscript{50} Article 2, paragraph 2, Directive 2006/46/EC.

\textsuperscript{51} FEE, Discussion Paper for Auditor's Role Regarding Providing Assurance on Corporate Governance Statements, Brussels, November 2005, p. 71.

\textsuperscript{52} Article 41, paragraph 2, sub a and b, Directive 2006/43/EC of 17 May 2006 of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157 of 9 June 2006, p. 87.

\textsuperscript{53} Article 41, paragraph 4, Directive 2006/43/EC.

\textsuperscript{54} European Corporate Governance Forum, Statement of the European Corporate Governance Forum on Risk Management and Internal Control, Brussel, 2006, p. 5.

\textsuperscript{55} Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52 of 25 February 2005, p. 61.

\textsuperscript{56} Turnbull Committee, Internal Control: Guidance for Directors on the Combined Code, London, ICAEW, 1999, section 16.

\textsuperscript{57} Turnbull Committee, Internal Control: Guidance for Directors on the Combined Code, London, ICAEW, 1999, section 18 and 30.
material controls, including financial, operational and compliance controls and risk management systems. The publication of the Walker Review of Corporate Governance in the UK Banking Industry in November 2009 raised questions as to whether the risk management systems and frameworks of the other industries also need a more modernized approach. The Financial Reporting Council acknowledged that further improvement of the internal control guidelines and reporting requirements is necessary, in particular regarding risk appetite assessment, tolerance and maintaining of the system. In the June 2010 the UK Corporate Governance Code the new main principle regarding internal control and risk management sounds: ‘The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.’

The French Companies Act – integrated in the Commercial Code – requires the board of directors to perform all controls and verifications that it considers expedient. Since 2003 the chairman of the board must present a report to the general meeting of shareholders with the internal control procedures and the risk management established by and in the company. The report must highlight those procedures related to the gathering and treatment of the accounting and financial information both for the annual and the consolidated accounts. This French legal requirement caused companies many compliance difficulties in particular due to the lack of guidelines. To overcome these problems, the French supervisory authority recommended the use of the referential framework ‘Le dispositif de Contrôle Interne: Cadre de référence’ of the Groupe De Place which the AMF sponsored. In 2008 a light edition ‘Cadre de référence du contrôle interne: Guide de mise en oeuvre pour les valeurs moyennes et petites’ for small and medium sized listed companies was published. The most recent 2010 editions of the AMF reports provide detailed guidelines on the requirement to report on internal control and risk management. Both reports clearly distinguished (reporting) requirements related to the general internal control framework and the more elaborated specific requirements with respect to the internal control over reporting of financial information. The French Commercial Code requires the chairman not only to report on the internal control procedures but also on risk management.

In the Netherlands the main internal control and risk management provisions are set out in principle II.1 of the Tabaksblat Code. The principle deals with the responsibility of the management board for complying with laws and regulations, managing the risks associated with the company’s activities, and financing the company. Furthermore, it stipulates that the management board has to report related developments to and discuss the internal risk management and control systems with the supervisory board and its audit committee. The best practice provisions required the management board to have an internal risk management and control system that is suitable for the company and declare in the annual report that the internal risk system are adequate and effective. The latter best practice provision is commonly known as the in control statement.

The Dutch monitoring commission provided guidelines to comply with the financial reporting risks and the other – operational, strategic and compliance – risks. It also offered good practices to portray the risk profile and the internal control and risk management system in the in control statement. The proposals have been incorporated in the new edition of the Dutch Corporate Governance Code of 2008 (DCGC 2008). The DCGC 2008 requires companies to have an internal risk management and control system suitable for the company with, as instruments of the system, risk analyses of the company’s operational and financial objectives and a monitoring and reporting system. Besides being responsible for complying with all relevant primary and secondary legislation and managing the risks associated with the company’s activities, the management board is also responsible for the company’s risk profile. In line with the Tabaksblat Code, the management board has to report related developments to and discuss the internal risk management and control systems with the supervisory board and the audit committee. The DCGC 2008 has amended the in control statement by requiring the management board to declare in the annual report that the systems provide a reasonable

58 Financial Reporting Council (FRC), The Combined Code on Corporate Governance, London, 2003, C.2.1.
59 Financial Reporting Council, UK Corporate Governance Code, London, June 2010, main principle C.2.
60 Article 225-35 section 3 of the French Commercial Code.
61 Both reports can be downloaded from www.amf-france.org.
62 AMF, Les dispositifs de gestion des risques et de contrôle interne - Cadre de référence : Guide de mise en oeuvre pour les valeurs moyennes et petites, July 2010, 10 p.
63 Tabaksblat Committee (Corporate Governance Committee), The Dutch corporate governance code: Principles of good corporate governance and best practice provisions, 2003, Best practice provisions II.1.3 and II.1.4, p. 9
64 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision II.1.3.
65 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision II.1.
assurance that the financial reporting does not contain any errors of material importance and that the systems have worked properly.66 Thus, instead of declaring that the systems are adequate and effective, the management board has to declare that the system provides reasonable assurance, which is a major reduction of the requirement. Since 2009 the declaration only has to address the financial reporting – not other aspects of the system such as strategy, operations and compliance – and only for errors of material importance. However, the DCGC 2008 added a provision requiring the management board to give a description in the annual report of: (1) the main risks related to the strategy of the company; (2) the design and effectiveness of the internal risk management and control systems for the main risks during the financial year; and (3) any major failings in the internal risk management and control systems, including significant changes made to the systems and the major improvements planned, and a confirmation that these issues have been discussed with the audit committee and the supervisory board.67 The system set out by the COSO reports is cited as an example of an internal control and risk management system in the explanatory statement.68 Also, the DCGC 2008 provides that the supervisory board’s oversight of the management board has to include the company’s risks inherent to the business activities and the design and effectiveness of the internal risk management and control systems.69 One of the key committees of the supervisory board, the audit committee, has to monitor the activities of the management board with respect to the operation of the internal risk management and control systems.70

In light of the financial crisis the DCGC will not be strengthened. However, like in the UK, a new Banking Code was issued in September 2009. It is applicable on all Dutch licensed banks. The code provides in a risk appetite approval and risk monitoring procedure as well as a product approval process. A risk committee must assist the supervisory board in its risk monitoring role.71 It is expected that the comply or explain code will be legally endorsed. In the mean time a monitoring commission assesses the compliance with the Banking Code.72

Germany was the first Western European country that legally endorsed a specific risk management system, the 1997 Frühwarnsystem. Conversely, Germany was very late in the development of a generally accepted corporate governance code. The code was published in 2002 and obtained the status of a mandatory comply or explain code via section 161 of the German Companies Act. It did not contain many guidelines regarding internal control or risk management. It explicitly recognizes the management board’s responsibility for risk management and the requirement for the chairman of the management board to discuss risk management with the chairman of the supervisory board. The audit committee must ‘handle issues of accounting and risk management’.73 In the 2005 edition the commission added that the chairman of this committee must have knowledge of and experience in internal control processes.74 Other or more detailed governance regulations are not included in the code. The financial crisis did not yet result in more specific risk management guidelines in the code.

Finally, Belgium followed the developments in the other countries. Belgium established a corporate governance commission that issued its code late 2004. It contained several internal control and risk management related provisions and guidelines. First, it is explicitly acknowledged that the board is responsible to enable the company to identify and to manage its risks and to define its risk appetite.75 The board must ascertain that an internal control system that effectively identifies and manages risks including the compliance risks of which the effectiveness must be controlled by the audit committee, is in place. The executive management must establish internal controls for all different kinds of risks.76

In the 2009 edition the board of directors must approve and assess the implementation of the

---

66 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision II.1.5.
67 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision II.1.4.
68 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, p.39.
69 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision II.1.6.
70 Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions, 2008, Best practice provision III.5.4.
71 NVB, Banking Code, September 2009, p. 16.
72 De Jager, J., 24 March 2010. Letter of the Minister of Finance, available at www.dnb.nl/openboek/extern/file/dnb_tcm40-197407.pdf last accessed 22 November 2010.
73 German Government Commission, German Corporate Governance Code, 2002, provisions 4.1.4., 5.2. and 5.3.2.
74 Government Commission, German Corporate Governance Code, 2005, provision 5.3.2.
75 Belgian Commission Corporate Governance, The Belgian Code on Corporate Governance, 2004, provision 1.1 and provision 1.2.
76 Belgian Commission Corporate Governance, The Belgian Code on Corporate Governance, 2004, provision 1.3, 6.5 and 5.2.7.
internal control and risk management framework.\textsuperscript{77} The most important characteristics of the framework must be disclosed in the corporate governance statement, a European disclosure requirement which is recently endorsed by a new corporate governance law.\textsuperscript{78} Furthermore, not only for the members of the audit committee but for all board members an induction programme with the fundamentals of risk management and internal control must be provided.\textsuperscript{79}

The most important requirements of each country are summarized in table 1. In most countries it the regulatory framework combines three topics: procedures, formal requirements and disclosure rules. It comes somewhat as a surprise that most of the regulatory frameworks are a patchwork combining some elements of the three different issues.

2. Demand for risk management

The legal supply of risk management requirements and disclosure raises questions what the market demand for risk management systems and reporting is. It requires determining which information the stakeholders and investment community wants for assessing their relationship with the company.

Risk management play a central role in the protection of investors’ interests promoting the timely identification, assessing and management of material risks that encumber on the business. By adequately reporting the risk management systems the reliability of the financial reporting increases. Information asymmetries between different corporate parties and in particular management and shareholders are reduced.

There is a growing body of literature that studies the disclosure of risk reporting. Since 2007 the International Financial Reporting Standard 7 requires the disclosure of financial instruments, accompanying risks and risk management systems. It fostered academic research on risk reporting and in particular financial risks. However, most of these studies analyze how companies inform investors\textsuperscript{80} but do not address the information demand of investors and other stakeholders.

Several techniques are available to discover this demand: questioning the investment community, measuring the abnormal returns around the event day when information on risk management or risk related items are disclosed, assessing the impact of risk management on future earnings, and risk management as a tool to substitute other techniques of internal control.

The first technique is directly questioning the investors and other stakeholders. Only limited discouraging results are available. In the US Epstein and Pava disclosed that only a limited number of investors read the MD&A compared to other parts of the report. They conclude: “Decision making is a function of expectations about future events. An yet, MD&A, which requires a discussion of future trends, scores very low in terms of usefulness relative to the other statements, which are primarily historically based. This finding suggests that MD&As, as currently issued, are not meeting their potential.”\textsuperscript{81} A study of investment behaviour of fund managers gathered the types of corporate governance or social responsibility issues that consumed most time in their engagement activity. Remuneration and board composition were mentioned by more than 50 per cent of the respondents, only one out of seven referred to risk management.\textsuperscript{82}

\textsuperscript{77} Belgian Commission Corporate Governance, The Belgian Code on Corporate Governance, 2009, provision 1.3.
\textsuperscript{78} Law of 6 April 2010 tot versterking van het deugdelijk bestuur bij de genooterde vennootschappen en de autonome overheidsbedrijven en tot wijziging van de regeling inzake het beroepsverbod in de banken financiële sector, Official Gazette 23 April 2010, p. 22709.
\textsuperscript{79} Belgian Commission Corporate Governance, The Belgian Code on Corporate Governance, 2009, provision 4.8.
\textsuperscript{80} See for example for the UK: P. Linsley and P. Shrives, “Risk reporting: A study of risk disclosures in the annual reports of UK companies”, The British Accounting Review 2006, vol. 38, pp. 387-404, P. Linsley and M. Lawrence, “Risk reporting by the largest UK companies: Readability and lack of obfuscation”, Accounting, Auditing & Accountability Journal, 2007, vol 20, pp. 620-626; for the Netherlands: W. Kevelam and R. Ter Hoeven, “De risico’s van financiële instrumenten”, Finance&Control 2008, pp. 35-41 and for Belgium: A. Michiels, S. Vandermael and P. Vergauwen, “Risicorapportering door Belgische beursgenoteerde bedrijven”, Accountancy & Bedrijfslust 2009, pp. 3-11.
\textsuperscript{81} M. Epstein and M Pava, The Shareholder’s Use of Corporate Annual Reports, Jai Press, 1993, p. 99.
\textsuperscript{82} Trades Union Congress, Fund manager voting survey 2010, London, p. 70.
Table 1: Legal and regulatory requirements regarding risk management

| United States | Europe |
|---------------|--------|
| -disclosure of risk factors | -disclosure risks related to financial instruments |
| -CEO and CFO certifies responsibility for establishing and maintaining internal control | -description of main risks |
| -management assesses effectiveness of internal control for financial reporting | -description of characteristics of the system |
| -establishing audit committee for: | -establishing audit committee for: |
| * overseeing the accounting and financial reporting processes | * monitor the financial reporting process |

| Nederland | Groot-Brittannië | Duitsland | België | France |
|-----------|-----------------|----------|--------|--------|
| appropriate risk management system | Board provides system | identification of threatening risks | developing system (management) and monitoring system (board) | chairman discloses internal control procedures and risk management systems |
| "in control" statement | board identifies risk tolerance | reporting the effectivity of the system | |

Hermanson is more supportive about voluntary reporting on internal control. His study investigated the demand for internal control surveying 1350 users of internal control reports. Voluntary and involuntary reporting motivated management to improve internal controls and the monitoring role of audit committees. However respondents did not believe reporting on internal control improves protection against material fraud. 83

A second technique is the event study approach. In event study methodology the marginal returns to investors are estimated conditional on an event signal. It compares the total returns to returns unconditional on the event but conditional on prior information. The unconditional returns are used to compute the excess shareholder return around an event window.

In a recent study on the disclosure of material risk factors of American companies Campbell et al. translated qualitative risk management disclosures in quantitative data. 84 The three day return around the disclosure of the Form-10 K release date adjusted for other effects like size, market returns, growth and momentum shows a significant negative association between the risk factor disclosure section measured via the key word counts and cumulative abnormal returns. Investors seem to incorporate the risk factor disclosures in the stock price. More risk disclosure has a negative impact on the stock price. It suggests that more elaborate communication on risk management systems is not appreciated by the stock market. A finding which causes careful assessment: more differentiation is needed whether risk disclosure is focusing attention of the investment community on the shortcomings of the corporate system or whether the risk disclosure stresses the fitness of the system. Control variables in the study suggest the latter finding is attenuating the negative relationship. If more analysts are following the corporation, the returns are less negative.

Another strand of the literature is focusing on the effects of the supervisory penalties. Armour, Mayer and Polo addressed the abnormal returns surrounding the Financial Services Authority’s penalties. 85 Only a number of the misdeeds can be traced back to risk management problems like the

83 H. Hermanson, “An Analysis of the Demand for Reporting on Internal Control”, Accounting Horizons, 2000, vol 14, nr. 3, pp. 325-341.
84 J. Campbell, H. Chen, D. Dhaliwal, H. Lu and L. Steele, The Information Content of Mandatory Risk Factor Disclosures in Corporate Filings, working paper, September 2010, 56 p. available at http://ssrn.com/abstract=1694279.
85 J. Armour, C. Mayor and A. Polo, Regulatory Sanctions and Reputational Damage in Financial Markets, working paper, Oxford University, September 2010, 42 p.
mis-selling of products and insufficient compliance with money laundering rules for which no detailed analysis is provided, overall the penalties caused significant negative abnormal returns in a two day event window (-1, +1).

Measuring the direct relationship between (disclosure of changes in the) risk management systems and abnormal stock price performance is confronted with noise. A number of studies indirectly measure the quality of the risk management system of the company. Keichtel, Lockett and Rao study illegal firm behavior in the 1980s.\textsuperscript{86} Their study finds that public announcements of indictments of corporate crimes have a significant and long-term negative impact on shareholder wealth, in particular if the company is found guilty. Larger firms experience relative impacts on returns. It suggests that risk management systems have a positive value. First it lowers the probability of corporate crime events and next it lowers the probability of the firm will be found guilty as case law, like the Caremark case indicate that appropriate compliance regimes lowers the probability of convictions.

Arnold and Engelen assessed 57 Belgian and Dutch cases between 1994 and 2003 and confirms the findings of Keichtel, Lockett and Rao that stock prices react negatively on the announcements date of corporate irregularities.\textsuperscript{87} Investors hardly react in case news on corruption is disclosed and reactions on cases of insider trading and tax fraud only had small effects on abnormal returns. Accounting fraud caused an abnormal return of more than 10 per cent two days before the disclosure in the financial press. The third technique is used by Feng Li when he addressed the influence of risk sentiment on future earnings.\textsuperscript{88} Building on the hypothesis that risk signals poor future performance, he found that an increase of the risk sentiment in the annual report is associated with lower future earnings. Risk sentiment is approached as the frequencies that risk related wordings are used. Extensive increases in risk reporting are followed by lower changes in earnings than low increases in risk reporting.

Finally, the literature measures the quality of the risk management and internal control disclosure via its power to mitigate agency problems. Corporations with lower management ownership and more dispersed ownership provide more information on internal control.\textsuperscript{89} The disclosure comforts the capital market. If the audit committee is composed of more accounting experts, the disclosure of internal control system is more limited.\textsuperscript{90} Corporate governance instruments are considered as substitutes. Similarly companies that are highly leveraged disclose more internal control information. In particular the risk management activities and monitoring by the supervisory board are considered important drivers to mitigate agency problems.\textsuperscript{91}

As far as we could ascertain, a technique of assessing the market demand similar to interviewing market participants has not been explored. Different market participants also disclosed assessment frameworks to measure the risk management system qualities of corporations. It provides insights in the needs of these participants vis-à-vis the risk management and internal control systems in place. At three different levels market participants disclosed their investment decision process and their considerations of the company’s risk management processes.

At the first level, investment managers make investment decisions on behalf of their beneficiaries based on a many selection criteria among which the reliability of the risk management system of the investee. TIAA-CREF, one of the largest public pension funds in the world provided insights in their risk assessment frameworks of the investees. For real estate companies TIAA-CREF divides the sources of risks in six classes, provide guidance as to how to measure the risk and how to manage the risks.\textsuperscript{92} Table 2 provides insights in the framework that TIAA-CREF proposed. TIAA-CREF stresses that it does not include the elimination of risk taking or developing cumbersome investment operation controls but an ongoing process of cooperation of risk managers and investment professionals. It particularly endorses the use of developed analytical tools to improve quantitative risk management.

\textsuperscript{86} A. Keichtel, M. Lockett and R. Rao, “The Impact of Illegal Business Practice on Shareholder Returns”, The Financial Review 1996, vol. 31, nr. 1, pp 67-85.
\textsuperscript{87} M. Arnold and P.-J. Engelen, Do Financial Markets Discipline Firms for Illegal Corporate Behaviour?, working paper Utrecht University, s.d., 8 p.
\textsuperscript{88} Li Feng, Do Stock Market Investors Understand the Risk Sentiment of Corporate Annual Reports?, working paper University of Michigan, 2006, 54 p.
\textsuperscript{89} R. Deumies and W.Kneche1l, Is Mandated Internal Control Reporting Necessary? The Experience of Listed Dutch Companies, working paper, November 2005, 40 p.
\textsuperscript{90} G. Michelon, S. Beretta, S. Bozolan, Disclosure on Internal Control Systems as a Substitute of Alternative Governance Mechanisms, working paper, February 2009, 40 p.
\textsuperscript{91} R. Deumies and W.Kneche1l, Is Mandated Internal Control Reporting Necessary? The Experience of Listed Dutch Companies, working paper, November 2005, 40 p.
\textsuperscript{92} M. Peyton and S. Bardzik, What is risk management and how does it apply to real estate?, TIAA-CREF, Fall 2008, 8 p.
Table 2: Risk management assessment of real estate of TIAA-CREF

| Source                     | Item                               | How to measure it                                      | How to manage it                                      |
|----------------------------|------------------------------------|--------------------------------------------------------|-------------------------------------------------------|
| Portfolio level risk       | investment concentration           | tracking error versus benchmark                        | monitoring, guidelines and limits                     |
|                            | asset correlations                 | portfolio performance volatility                       | strategy decisions, benchmarking, value at risk, measurement |
|                            | product correlations               |                                                        | tracking stule purity, monitoring, internal duration  |
|                            | product features                   |                                                        | monitoring refinancing risk                           |
|                            | leverage                           | proxies include the fees and targeted return on capital | operational risk management, audit activities, public relations and marketing expertise |
|                            | business                           | proxies include the fees and targeted return on capital | board oversight of high level business strategy and implementation |
|                            | operating risk                     | proxies include the fees and targeted return on capital | effective acquisition analysis, ongoing effective management of property construction and improvement, style guidelines and monitoring |
|                            | strategic risk                     | proxies include the fees and targeted return on capital | efficient property management and transaction execution, accurate acquisition and disposition analysis, effective market selection, efficient lease management, tenant exposure guidelines |
|                            | value-add and opportunistic risk   | spread related to higher risk investment styles, similar | effective acquisition analysis, ongoing effective management of property construction and improvement, style guidelines and monitoring |
|                            | core real estate-equity            | spread between corporate debt and real estate equity returns | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | core real estate-tenant credit risk| spread on investment grade and non-investment bond weighted to tenant composition and lease duration | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | availability and pricing of capital| cap rate spreads over treasuries compared with corporate debt spreads over treasuries | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | inflation                          | spread between Fed funds and 10-year Treasury         | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | real rate                          | presented by coupon on TIPS                           | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | country risk                       | JLL transparency index, instit. Investor rankings, transparency int. Corruption index, World Bank, IMF and rating agency analyses | monitoring and timing leverage decisions to take advantage of cycle low interest rates monitoring |
|                            | ownership structure risk           | proxies to measure these risks are not readily available | limits, due diligence requirements                     |
|                            | illiquidity                         | monitoring the flow of transactions on a property type and geographic basis to gauge the depth of the market, data from real capital analytics and NCREIF | asset-liability management, cash management, liquidity management |

Source: M. Peyton and S. Bardzik, *What is risk management and how does it apply to real estate?*, TIAA-CREF, Fall 2008, 3-5.
At the second level, credit rating agencies incorporate risk management in their process for rating issuers. Standard & Poors started to include enterprise risk management elements in their corporate credit ratings. S&P focuses on risk management culture and strategic risk management. In most risk management frameworks corporations use the culture is translated as the “tone at the top”, an important component of the framework whilst strategic risk is part of the entity objectives. Strategic risk management studies how management “weighs the risks in terms likelihood, potential effect on credit, liability management and financing decisions”. Addressing risk management S&P uses seven primary questions for discussing the risk management framework. The questions relate to the identification of the main risks, how management addresses the risks, what the board tolerates and how the board discusses risk management, the success of the risk management activities, the relationship between risks and incentive compensation and how the company responds to surprises.

At the third level, the International Accounting and Standards Board considers that management “should communicate information about an entity’s economic resources, claims on those resources and the transactions and other events and circumstances that change them.” In 2009 the IASB issue an exposure draft “Management Commentary” in which risk assessment is an important part (par 31 – ED/2009/6). ‘Management should disclose its principal strategic, commercial, operational and financial risks, being those that may significantly affect the entity’s strategies and development of the entity’s value.’ It further recognizes that ‘disclosure of an entity’s principal risk exposures, its plans and strategies for bearing or mitigating those risks, and the effectiveness of its risk management strategies, helps users to evaluate the entity’s risks as well as its expected outcomes’.

Table 3 summarizes the requirements of three “user” types of annual reports. All three emphasize the risk management procedures. None of these parties requires “formal” institutional frameworks but effective systems to identify and manage the risks.

93 Standard & Poors, Progress Report: Integrating Enterprise Risk Management Analysis Into Corporate Credit Ratings, July 2009, 5 p.
94 PWC, “S&P’s fresh look at risk: A Company’s credit rating will reflect its ability to handle risk”, Point of View, December 2008, p. 2.
95 Standard & Poors, Progress Report: Integrating Enterprise Risk Management Analysis Into Corporate Credit Ratings, July 2009, 5 p.
Table 3: Demand for risk management

| TIAA-CREF          | Standard & Poors       | IASB                        |
|--------------------|------------------------|-----------------------------|
| event identification| event identification   | disclosure of risk          |
| risk assessment    | risk assessment        | risk assessment             |
| risk response      | risk response          | risk response               |
|                    | monitoring (effectiveness) | monitoring (effectiveness)  |

3. Assessing the one-size-fits-all supply approach in light of the demand side

If we accept the idea that a flexible and adaptable governance structure of which risk management is an important constituent, could enhance welfare by promoting best practices that most firms prefer, then the task of policymakers and lawmakers should be to create institutions that contribute to the production of acceptable minimum standards. The work of standard-setting institutions, such as the IASB, are viewed to be successful if they produce legal standards and best practices that meet the needs of distinct firms on the one hand, while introducing provisions that reflect the ever-changing dynamics of the environment in which firms operate on the other. The process also serves to limit the effects of lock-in obsolescence when the standard-setting institutions are engaged in continuous revision of the corporate governance model against the background of changing market conditions. Due to the 'stickiness' of the regulatory frameworks, legislators and regulators should be careful with drafting and introducing overly rigid and detailed principles. Open norms, such as the duty of loyalty, and disclosure requirements arguably prove more effective in protecting shareholders and other stakeholders. Such an open norm could be viewed as a backstop mechanism that makes the application of the risk management framework contingent on circumstances that are verifiable by an adjudicator ex post, but prohibitively costly to identify ex ante. As Epstein and Pava already noted in their research of annual report’s effectiveness the MD&As can be very useful if basic conditions are considered. “Investors were asked if the MD&A section should be expanded to include forward-looking information about possible events that may effect the future of the company. Almost 90 percent of the respondents answered ‘yes’. The unusually high percentage of investors who responded affirmatively to this question, combined with the other results reported above, indicate that both the low readership and the low usefulness rankings, are, to a large extent, driven by the lack of forward-looking information contained in the MD&A.‖

It suggests that beyond the basic conditions on the disclosure of information formal institutional corporations’ frameworks are not proposed. Despite some antipathy to rules and regulations, business leaders have started to accept this field as an imperative for financial success on a global scale. Firms have been known to improve factors like board structures, financial transparency, disclosure policies and risk management systems to attract prospective investors.

Although it is acknowledged that many of these specific developments have created minimum standards and guidelines that actually improved the functioning of listed companies, it is far from clear whether more stringent and detailed rules and regulation would have a similar effect. Still, as we have seen above, policymakers and lawmakers seem to believe that a regulatory approach in the area of corporate governance and risk management will only enhance the accountability of directors, managers and controlling shareholders. Their efforts work on the assumption that these parties will better serve the interest of passive investors if they embrace rules and regulations that offer them clear guidance about the best way in which to discharge their fiduciary duties. To this effect, the argument that corporate governance rules can clarify and supplement these duties has often been used to support the idea that firms do not really bear high costs from reform measures in this area.

Opponents of the regulatory view, who believe that risk management should be an integral part of business strategy and not be considered as a goal in itself, but rather as a tool to improve firm performance, argue that the corporate governance risk management initiatives have been far too overreaching. In fact, the current reform movement has spawned many cumbersome rules which do not seem to prevent corporate failures and, more importantly, appear to have only a relatively small effect on investment decisions. Unchecked, this

96 M. Epstein and M Pava, The Shareholder’s Use of Corporate Annual Reports, Jai Press, 1993, p. 102.
development could jeopardize entrepreneurship, innovation and long term economic growth. For instance, corporate governance regulations and cumbersome risk management requirements have induced small firms to rethink their stock exchange listing. In this respect, corporate governance and risk management rules and regulations act as an entry barrier for high-potential companies.

To see what the effect of a flexible, instead of sticky and over-regulatory, corporate governance and risk management framework is on the development of high potential growth companies, we can examine and compare the ranking of other companies in the FT Global 500 2010. There are three points of interest in this comparison: (1) it is remarkable that a large number of relatively young US companies are represented in the ranking; (2) US companies dominate the top 100 of the ranking; and (3) starting (or moving) a high potential growth company in (to) the United States seems to increase the chances of success. Based on this information, we claim that flexible company law and corporate governance structures which contribute to a low access level to the financial market, prove more successful for high growth companies in the long run. Although the American capital market is probably the most regulated market in the world, to a large extent the regulation is focusing on appropriate and sufficient disclosure of information and less on formal organizational issues. The Sarbanes-Oxley Act introduced a limited number of organizational requirements which resulted in a decline in the attractiveness of the American capital market but a more flexible interpretation of the requirements in the final SEC rules and the introduction of many mandatory requirements in other countries repositioned the American exchanges as one of the top players.

Certainly, at a time of corporate scandals and economic stagnation, it is hard to make the case that companies in jurisdictions with a flexible corporate governance structure and risk management system eventually outperform companies in jurisdictions with strict and rigid corporate governance rules and regulations. Most commentators explain that if Europe were to replicate the entrepreneurial environment of the United States, it should give priority to establishing high labour mobility and risk tolerance, a well-developed stock market, and large, independent sources of venture capital funding. However, despite these arguments, this research seems to indicate that flexibility and adaptability of the corporate governance framework and risk management system also play a pivotal role in the development of high potential growth companies in Europe. It requires another attitude of both the European legislator and the national regulators that both developed “one size fits all” models with which companies struggle to comply will probably not foster economic growth.

---

97 It is also based on a similar conclusion in J. Mendoza, C. Van der Elst and E. Vermeulen, Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe, Topics in Corporate Law and Economics working paper 2010-2, 2010, 37 p.