5 tactics for writing about risk and uncertainty in your annual report

By Matthew Leitch

While the FRC has been ramping up its requirements on reporting about risk management, some old challenges remain.

How do you write about risk and uncertainty without sounding boring or weak, especially if things haven't gone according to plan and analysts have not been sympathetic? To help you tackle these challenges, here are some simple tactics for dealing with risk and uncertainty in your annual report:

1. Discuss inevitable uncertainties in your market overview and explain how you respond to them throughout your report.

A lot of the uncertainty companies grapple with is not their fault. The economy rises and falls, often unpredictably. Competitors exist and do things to make life difficult. Technology moves on. Consumers change their tastes. These are just some of the inevitable uncertainties that all companies face. There will be others faced by all companies in your markets. So don't feel embarrassed about acknowledging them.

Discussing these thoroughly in your market overview, within your Strategic Review, frames these uncertainties appropriately as key features of the business environment in which you operate. It shows that you are aware of them and understand them. It also sets the scene for further helpful material about management later on.

When you describe your strategy you can explain how elements of it deal with those key uncertainties. Perhaps your strategy has flexibility built in. Perhaps you are diversified. Perhaps you continually review and revise your product portfolio to adapt to rising and falling markets. Or perhaps you believe that your product is timeless – and you have facts to back that up.

Similarly, when you describe your business model, there may be elements of it that help you deal with those inevitable uncertainties and so you can explain them. There may be yet more you can say when you describe your approach to management, the way you do financing and tax planning, and when you present your graphs of KPIs.

As well as discussing those inevitable uncertainties in the market overview, show some time series graphs of them, such as macroeconomic or market indices, because this will show, without need for explanation, their irregular fluctuations. They also give you an opportunity to describe how you have used your mitigation strategies in the past and how they have helped.

2. Split your principal risks and uncertainties.

The familiar table of principal risks and uncertainties is usually presented as a single lump interrupting the flow of your exposition and duplicating points you have made elsewhere. Instead, why not split that table into two or three tables and place them where they are relevant?

The big, inevitable uncertainties in your business environment can be listed as a block of "external" risks and uncertainties placed near elements of your strategic priorities or business model that relate to them. Risks more relevant to your internal processes or transformation challenges can be placed near strategic priorities or elements of your business model that relate to those risks.

3. Describe how you monitor and adjust.

Text on principal risks and uncertainties is an opportunity to talk about how you monitor and adjust, showing readers that you are aware of concerns and actively managing them. For example, if analysts are worried about a competitor, even one that poses no immediate threat, you can reassure them by explaining how you monitor competitors and the adjustments you can make. This is better than just telling the analysts there is nothing to worry about.

Your statements about risk management, going concern, and viability provide further opportunities to make points like this and there is nothing to stop you making them within the main text on business strategy and business model. Just pick the most appropriate places.

4. Accompany predictions with relevant facts.

Occasionally you will want to make statements about the future, and usually you will express them with a probability phrase rather than make a definite prediction. For example, you might write something like "We think it unlikely that market prices will return to pre-recession levels within the next two years." The probability phrase in this example is 'unlikely'.

Unfortunately, views of probabilities are hard for readers to weigh exactly so reinforce your point by juxtaposing one or two facts that are the main reasons for your belief. With the example above you might introduce your forecast with "Due to continuing low interest rates and the lack of any upturn to date, we think …"

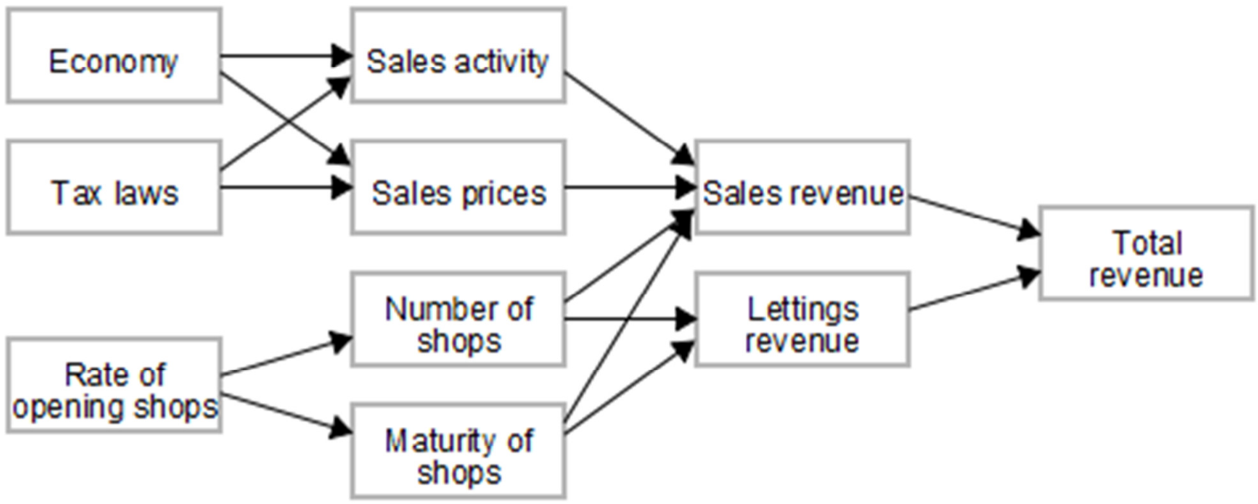
Alternatively, give the facts just after the prediction. For example, "We think our market share is likely to increase further during the next 18 months thanks to the protection provided by our key patents."

5. Work to a single conceptual model.

It is normal and to some extent healthy for people who work together to look at the world in different ways and to disagree.

Unfortunately, it is confusing for readers of your annual report to be confronted with that. If the Chief Executive says that five variables are crucial drivers of the results but the Chairman seems to say that the main drivers are three quite different variables, and the Chief Financial Officer writes about yet another set of variables, then readers are confused. The one thing they know for sure is that at least two of those three writers have the priorities wrong.

To build at least some consensus, try drawing a conceptual diagram of the reasoning



in last year's report or this year's draft. Use boxes or bubbles for variables and linking arrows for causal links between them.

This kind of diagram has been variously called a conceptual map, a causal map, and a strategy map. You could do a mind map on a sheet of A3 paper. A picture like this doesn't capture everything needed to express an understanding of how a business works, but it does create a skeleton that is helpful for a team of people working on an annual report. Just focus on the items important enough to mention in your Strategic Review.

Usually the situation is more complex than just a list of drivers of results, and two or three layers of causal links may be involved. The illustrative example above is part of a map for a company that owns a chain of estate agents.

The diagram reflects the fact that tax laws and the economy drive sales of properties and their prices, which in turn drive sales revenue. Lettings revenue is not as variable. However, both types of revenue are driven by the number of branches they have open and the maturity of those branches. The group's strategy is to keep opening new branches but the rate of opening is important. New branches take a while to mature so too many new branches would add costs but not raise revenue as much.

If you don't like diagrams like this then you could summarise the causal links in text instead. The key point is to have a condensed, clear statement of the mental model the report is using and encourage writers to keep it in mind as they write their sections. It isn't for publication – just to help you get to something good to publish.

The variables and their links will be relevant to lots of the main text in the Strategic Review, to the principal risks and uncertainties, to KPIs, and to the statements on going concern and viability.

The principal, inevitable uncertainties in your business environment will normally feature strongly at the input end of your diagram (e.g. the economy, tax laws), with financial results and factors affecting your tax charges appearing near the other end.

Putting the tactics together

If the tactics described above are used together properly, the various sections of your report (especially the Strategic Review) will show that your company is well designed and well run to thrive in its business environment, despite the challenges that companies inevitably face. The material on principal risks and uncertainties becomes part of the narrative, in the places where it does the most good and focused on what matters to readers. The board will show it has a coherent understanding of the company and its environment, and that it leads in a responsible, intelligent way, anticipating and adapting to events as well as setting a wise course and overseeing progress.

This contrasts sharply with an alternative approach that companies sometimes try and that we think does not work. That approach is to focus relentlessly on the positive, excluding all material that is even slightly negative. The company is portrayed as invincible, setting out its goals and expecting to achieve them with such confidence that the business environment is irrelevant. Worries that investors and analysts might have are ignored or brushed aside with simple statements of conviction. Material on risk and uncertainty is boxed and condensed to present it as just another boring regulatory formality. The chairman's smiling photograph sits over congratulations to the board and the company on another great performance, regardless of results and prospects.

It's obvious that a struggling company will not win over opinion formers with a show of breezy confidence. But even a company that is going through a very good period can show itself as stronger and better led by talking openly about its environment and how it thrives in that environment. It can show that it's not just a lucky company riding on the crest of a favourable wave, but that it is intelligently poised on that wave, ready to survive a spill, and looking for the next waves to ride.

The Author: Matthew Leitch is an author, consultant, and researcher who has written two books about risk management. His varied career includes several years as a controls specialist with PricewaterhouseCoopers and time spent in marketing, technical writing, and software development. He has been an independent consultant for over a decade and has worked on an award winning annual report for a UK company with Jonathan Hayward of Independent Audit.