National and International Developments in Risk Reporting: May the German Accounting Standard 5 Lead the Way Internationally?

*By Michael Dobler**

A. Introduction

In this journal, Buchheim and Beiersdorf discussed recent changes in the regulation of the management report (*Lagebericht*) in Germany.[1] The German Commercial Code (*HGB – Handelsgesetzbuch*) requires a management report by individual entities classified as companies with limited liability in § 289 and by groups in § 315. The reporting requirements of the latter are specified by the German Accounting Standard GAS 15 on *Management Reporting*. The authors award the German regulation to potentially lead the way internationally.

More specifically, their article addresses risk reporting, which is an integral part of the management report. While risk reporting has been explicitly required in Germany since 1998, equal requirements have become mandatory in all member states of the EU only recently in 2005.[2] In Germany, the reporting requirements are specified by accounting standards issued by German private standard-setting

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1 See Regine Buchheim/Kati Beiersdorf, *New Developments in Management Reporting – The Modernisation of the Annual Report*, 6 GERMAN LAW JOURNAL 861-868 (2005) www.germanlawjournal.com.

2 See Directive 2003/51/EC of June, 18th, 2003, Art. 1(14)(a), Art. 2(2)(a).

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bodies. These include GAS 5 on *Risk Reporting* issued in 2001, which is assigned a forerunner role in standardising risk reporting.[3]

By discussing national and international developments in the regulation of risk reporting involving German legislation, German standards, EU directives, international and US standards, this article provides an international comparative overview of mandatory risk disclosures and a perspective for international convergence. Both is assessed with particular regard to GAS 5, which still is the only standard on comprehensive risk reporting world-wide.

B. Risk Reporting According to German Accounting Regulation

The German HGB requires risk disclosures in the annual management report. As the HGB fails to specify the concrete risk reporting requirements private standard-setters attended the issue. These are the German Institute of Certified Public Accountants (*IDW – Institut der Wirtschaftsprüfer in Deutschland*) and the German Accounting Standards Board (*GASB – Deutscher Standardisierungsrat*). The former issues standards addressing auditors of individual and group accounts, while the latter shall develop standards specifically concerning group accounts. The GAS issued by the GASB cannot directly standardise individual accounts. GAS are assumed to be consistent with German accounting principles if they are published by the Federal Ministry of Justice (*BMJ – Bundesministerium der Justiz*).[4]

I. German Commercial Code

Reacting on prominent corporate crises and breakdowns, in 1998, the Law on Corporate Control and Transparency (*KonTraG – Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*) amended §§ 289(1), 315(1) HGB by requiring disclosures on the risks of the entity's future development in the management report. The accounting profession labelled this explicit requirement as risk reporting (*Risikoberichterstattung*). Risk was not interpreted in a broad but rather in a narrow sense, which excludes chances. Accountants regarded the amendment as a novelty and a reporting challenge. However, the former §§ 289(2) No. 2, 315(2)

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[3] See, e.g., Peter Kajüter/Carsten Winkler, *Die Risikoberichterstattung der DAX100-Unternehmen im Zeitvergleich*, 3 ZEITSCHRIFT FÜR KAPITALMARKTORIENTIERTE RECHNUNGSLEGUNG 228 (2003); GASC, *Deutscher Standardisierungsrat beschließt Neuausrichtung*, Press Release www.standardsetter.drsc/docs/press_releases/gasb_restructuring.html (July 25th, 2003).

[4] See § 342 HGB; Dieter Ordelheide, *Germany – Group Accounts*, TRANSNATIONAL ACCOUNTING 1385-1368 (Dieter Ordelheide/KPMG (eds.), 4th ed. 2001).

No. 2 HGB demanded to address the entity's expected future development. As this includes risks and chances, the narrow interpretation of risk (excluding chance) is unbalanced, and the codification of the risk report is rather declaratory from a regulatory point of view. Only given the poor forecast disclosure in practice before the amendments the explicit duty to issue a risk report which is subject to an audit implies a challenge to the accounting profession.[5]

A disclosure requirement similar to the risk report in Germany was introduced by the Modernisation Directive 2003/51/EC amending the 4th and the 7th Company Law Directives. By 2005, risk reporting is mandatory in all member states of the EU. While the German legislation has been leading the way in this regard, recent European Directives were transformed by the Reform Act on Accounting Regulation (*BilReG – Bilanzrechtsreformgesetz*) amending the German risk reporting requirements. First, the Modernisation Directive requires a description of the principal risks and uncertainties that the entity faces.[6] While this is largely equivalent to the risk reporting requirement according to the *KonTraG*, the transformation lead to formal amendments. §§ 289(1) and 315(1) HGB now require to assess the entity's expected future development with its material risks *and* chances; forecast assumptions shall be disclosed. Similar as discussed above, this is a rather declaratory amendment which clarifies that disclosures on risks and chances are required. Second, the Fair Value Directive 2001/65/EC requires disclosures about the entity's financial risk management objectives and policies and the entity's exposure to price risk, credit risk, liquidity risk, and cash flow risk.[7] This was transformed in §§ 289(2) No. 2, 315(2) No. 2 HGB, thereby withdrawing the former requirement to report on the entity's expected future development, now codified in §§ 289(1) and 315(1) HGB.

II. Professional Standards

Neither the German Commercial Code nor the corresponding legislation material specify the comprehensive risk reporting requirements of §§ 289(1) and 315(1) HGB. This was left to private standard-setters.

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[5] For a discussion see Michael Dobler, *Auditing Corporate Risk Management – A Critical Analysis of a German Particularity*, 1 THE ICFAI JOURNAL OF AUDIT PRACTICE No. 2 51-52, 56-57 (2004).

[6] See Directive 2003/51/EC, Art. 1(4)(a) amending Art. 46(1)(a) of Directive 78/660/EEC, and Directive 2003/51/EC, Art. 2(10)(a) amending Art. 36(1) of Directive 83/349/EEC.

[7] See Directive 2001/65/EC of September 21st, 2001, Art. 1 (4) amending Art. 46(2) of Directive 78/660/EEC, and Directive 2001/65/EC, Art. 2 (3) amending Art. 36(2) of Directive 83/349/EEC.

In 1998, the *IDW* issued a standard IDW RS HFA 1 to specify the disclosure requirements in individual and group management reports. This incorporates rules on risk reporting.[8] These are rather general and not legally binding.[9] But the standard provided prompt guidance for the accounting profession in respect to the *KonTraG*.

On April 3rd, 2001, the GASB issued a more detailed standard GAS 5 specifically on risk reporting. GAS 5 could build on and is fully compatible with IDW RS HFA 1. But the binding scope of GAS 5 is limited to group risk reporting.[10] A recent revision of GAS 5 stresses its connection to GAS 15 on management reporting, thereby impairing the individual significance of GAS 5.[11] GAS 5 requires information about risks that could affect decisions of the users of risk reports. This scope is extensive. However, risk is interpreted in the narrow sense as "the possibility of a future negative impact on the economic position"[12]. Chances are not accounted for in general. The partitioning references to distinguish risks (in the narrow sense) and chances are the economic position on the balance sheet date and management's expectations of future development as reported in the management report. Formally, the risk report must be disclosed in a in self-contained section of the management report, particularly separated from the disclosures on the expected future development.[13] The contents shall focus on entity-specific risks and risk concentrations.[14] Risks endangering corporate going concern must be labelled as such. The risk report shall be self-contained and shall describe individual risks and explain their possible consequences.[15] The latter incorporates an assessment of the probability and the damage effects of risk realisation.[16] However, risks do not need to be quantified unless several criteria are met.[17] Risk assessment shall base on an

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8 See IDW RS HFA 1.29-36 (*IDW Stellungnahme zur Rechnungslegung Hauptfachausschuß 1*).

9 In a general decision, the local court of Duisburg decided that bulletins of the *IDW* may have particular authority. However, they cannot substitute the legal interpretation by a court. See Amtsgericht Duisburg, *Beschluß v. 31.12.1993, 23 HR B 3193*, 47 DER BETRIEB 466-467 (1994).

10 See GAS 5.1, .3. GAS 5.8 recommends to apply GAS 5 to risk reports of individual companies.

11 See *Deutscher Rechnungslegungsänderungsstandard* 3, issued on July 15th, 2005, Art. 9.

12 GAS 5.9.

13 See GAS 5.30-33.

14 See GAS 5.12-13.

15 See GAS 5.15.

16 See GAS 5.18-19.

appropriate forecast period, assuming a horizon of about two years in general.[18] Specific disclosure requirements address inter-dependencies between risks,[19] exceptional references to chances,[20] cross-references to other parts or sections of the accounts,[21], and risk handling techniques and their effects.[22] Moreover, the risk management system must be described.[23]

GAS 5 is supplemented by two industry-specific standards. GAS 5-10 requires special disclosures for financial institutions and financial service institutions. GAS 5-20 supplements the general standard with rules for insurance enterprises. The revised IDW RS HFA 1 and the recently issued GAS 15 refer to GAS 5 in respect of risk reporting in the group management report.[24]

III. Discussion

Concerning the HGB, reporting on the entity's expected future development implicitly required prospective risk and chance reporting even before the *KonTraG*. The *KonTraG* explicitly demanded the disclosure on risks of the entity's future development, which was (mis)interpreted to focus on risks in the narrow sense. Finally, the *BilReG* highlights that a prospective report on risks in the broad sense, including chances, is required. This implies that the amendments to §§ 289(1) and 315(1) in respect to risk reporting are merely declaratory.

Given that §§ 289(1), 315(1) HGB as amended by the *BilReG* explicitly require disclosures on risks and chances besides an explanation of the forecast assumptions, GAS 5 falls short in two ways. First, GAS 5 does not demand a description of the forecast arguments and techniques. Second, GAS 5 demands disclosures on risks in the narrow sense, but not on chances. Both is mitigated when

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17 See GAS 5.20, cumulatively requiring „reliable and recognised methods“, the absence of „undue economic expense“ and effects of the quantification on „the decision of users“.

18 See GAS 5.23-24.

19 See GAS 5.25.

20 See GAS 5.26-27.

21 See GAS 5.31.

22 See GAS 5.21.

23 See GAS 5.28-29.

24 See IDW RS HFA 1.52; GAS 15.83.

reading GAS 5 in connection with GAS 15, as highlighted by the latest revision of GAS 5. But still the risk report must be presented in a self-contained section of the management report.[25] This formally tends to highlight risks compared to chances, thereby violating the principle of neutrality. By requiring a description of the risk management system, GAS 5 exceeds the risk management disclosures amended by the *BilReG*, which only refer risk management in regard to financial instruments.

Due to the comparatively more binding character of GAS 5 concerning group accounts, IDW RS HFA 1 was amended in late 2001. It refers to GAS 5 in respect of group risk reports.[26] On the other hand, GAS 5.8 recommends to apply its rules to individual risk reports. The *IDW* standard does not follow this recommendation. Thus, formally there are different standards for individual and group risk reports in Germany. This distinction is unusual in international accounting standardisation.

C. Risk Reporting According to Internationally Accepted Accounting Standards

A growing number of listed German entities have published group accounts complying with internationally accepted standards during the last decade. Under certain conditions § 292a HGB allowed to present group accounts according to International Financial Reporting Standards (IFRSs) or according to US Generally Accepted Accounting Standards (US-GAAP) instead of group accounts according to HGB accounting rules in the period from 1998 to 2004. From 2005 on, capital market oriented companies are required to present group accounts complying with IFRSs based on Regulation EC 1606/2002 on the application of international accounting standards.[27]

Irrespective of the accounting standards applied for the group accounts, § 315 HGB requires a group management report incorporating the risk report. Thus, GAS 15 and GAS 5 are still relevant for all German groups. But those applying US-GAAP or IFRSs must disclose additional risk-related information demanded by internationally accepted accounting standards.

I. US Generally Accepted Accounting Standards

[25] See GAS 5.30-33; GAS 15.83, .91.

[26] See IDW RS HFA 1.52.

[27] See Regulation 1606/2002 of July, 19th, 2002; § 315a HGB implemented by the *BilReG*.

Although the *Securities and Exchange Commission* (*SEC*) requires annual risk-related disclosures in Form 20-F or Form 10-K for firms listed in the US, the SEC requirements are out of the scope of US-GAAP.[28] Thus, US-GAAP demand neither a Management's Discussion and Analysis of Financial Condition and Operations nor the Operating and Financial Review and Prospects, which both require risk-related disclosures and may be partially comparable to the management report.[29] However, US-GAAP comprise several rules on mandatory risk disclosures. They include:

loss and gain contingencies;[30]
risks and risk management associated with financial instruments;[31]
certain significant risks and uncertainties in estimates;[32] and
risk concentrations with potentially severe impact on the entity or arising from major customers.[33]

II. International Financial Reporting Standards

IFRSs do require no reporting instrument either similar to the German management report or to the German risk report. The former recommendation to disclose a financial review was withdrawn by the revision of IAS 1 in the course of the Improvements Project of the *International Financial Reporting Standards Board* (*IASB*) in 2003. IAS 1.9 now only states that many entities present such reports, which are outside the scope of IFRSs. While IFRSs comprise no comprehensive standard on risk reporting, there are several rules on specific risk disclosures. They cover:

contingent liabilities and assets;[34]
risks, risk concentrations, and risk management associated with financial instruments;[35]

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[28] See, e.g., Statement of Auditing Standards (SAS) 69; Miller/Redding/Bahnson, THE FASB – THE PEOPLE, THE PROCESS AND THE POLITICS 61 (4th ed., Boston et al. 1998).

[29] See Form 20-F, Item; Form 10-K, Item 7; Regulation S-K, Item 303.

[30] See Statement of Financial Accounting Standards SFAS 5.9-12; SFAS 5.17 read in connection with Accounting Research Bulletin ARB 50; SOP 94-6.11-16.

[31] See SFAS 133.44-45.

[32] See Statement of Position SOP 94-6.11-16.

[33] See SOP 94-6.21-24; SFAS 131.39, .108.

[34] See International Accounting Standard IAS 37.10, .89-92.

specific uncertainties in estimates;[36] and
material going concern uncertainties.[37]

III. Discussion

While there are many differences in detail between US-GAAP and IFRSs, most noticeably, US-GAAP do not require going concern disclosures. In the US, going concern uncertainties are not explicitly addressed by accounting standards but by the audit standard SAS 59.[38] This is, not the disclosing entity but its auditor must report on material uncertainties endangering the entity as a going concern.

A comparison of GAS 5 with the internationally accepted standards on risk reporting yields general differences in standardisation, presentation, and material reporting requirements. While US-GAAP and IFRSs comprise several risk reporting requirements in different and interrelated standards GAS 5 is the only self-contained standard that exclusively regulates risk reporting in a comprehensive way.[39] Similarly, GAS 5 requires a self-contained risk report in the management report, whereas risk disclosures are presented in a no self-contained manner in the notes according to US-GAAP or IFRSs.[40] As regards content, risk reporting according to the HGB and GAS 5 differs from the risk disclosures required by US-GAAP and IFRSs in three major ways:

First, the German risk reporting approach is broader in scope. It requires a comprehensive risk report covering all risk categories whereas US-GAAP and IFRSs focus on risks of certain specific categories, mainly financial risks. But concerning risks associated with financial instruments, both US-GAAP and IFRSs exceed GAS 5 by requiring more detailed and quantitative information. Second, GAS 5 understands risk in the narrow sense, excluding chances. US-GAAP and IFRSs do not explain their understanding of risk but concentrate on uncertainty or risk in the broad sense or on risk factors rather than on risk in the narrow sense.

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35 See IAS 32.52-85; ED 7.

36 See IAS 1.116-122.

37 See IAS 1.23-24.

38 See Donald E. Kieso/Jerry J. Weygandt/Terry D. Warfield, INTERMEDIATE ACCOUNTING 1296 (11th ed. 2003).

39 One could argue that SOP 94-6 in the US is also a standard dealing with risk related disclosures. However, SOP 94-6 must be read in connection with SFAS and only addresses some specific risk disclosures.

40 To digress briefly, the *Institute of Chartered Accountants in England and Wales* issued a proposal for a Statement of Business Risk in 1997. However, the proposal did not become a standard.

Third, GAS 5 demands direct forecasts, whereas the international standards fall short on direct forecast or even state that forecasts are not necessary in certain contexts.[41] This highlights a conceptual difference between the German and the international, especially the US risk reporting approach. The latter aims to provide a sound basis allowing the users to derive their own forecasts, but is sceptical to provide direct forecasts due to issues of reliability.

D. Developments and Convergence

While convergence is a main topic in accounting regulation the discussion has concentrated on convergence of annual financial accounts according to IFRSs and US-GAAP. It is scarcely concerned with supplemental reporting instruments like the risk report. However, recent developments in risk reporting show that the topic attracts growing attention and involves national standard-setters, like the GASB, as well as the EU and the IASB.

GAS 5 was affected by both the national standard IDW RS HFA 1 and international accepted accounting standards. E.g., the requirement to describe risk management in general could not and cannot be deducted from § 315(1) HGB, but it has forerunners in disclosure requirements according to US-GAAP and IFRSs. In addition, the special disclosure requirement on risk concentrations originates from SOP 94-6.[42] Despite there are two standards concerning risk reporting in Germany, GAS 5 provides more detailed rules and may attract more attention internationally. The latter stems from the availability of the standard in English language[43] and the representation of the responsible standard-setter GASB in international standard-setting committees. Based on the fact that GAS 5 is the first self-contained standard on comprehensive risk reporting, the German accounting literature supposes GAS 5 to potentially lead the way internationally. Despite some deficits in its rules,[44] GAS 5 may guide standard-setting in two major ways.

First, the EU Modernisation Directive that requires risk disclosures in the management report equal to those specified by GAS 5. GAS 5 may serve as an

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41 See, e.g., IAS 1.116.

42 See Draft-GAS 5.B3 (Reasoning).

43 While GAS are available in English language in general, Draft-GAS 5 is the first and only draft of a GASB-standard issued in English. See www.standardsetter.de/drsc/docs/drafts/5_eng.html for Draft-GAS 5 published on November 24th, 2000.

44 For a detailed analysis of GAS 5 see Michael Dobler, RISIKOBERICHTERSTATTUNG – EINE ÖKONOMISCHE ANALYSE 162-181 (Frankfurt am Main 2004).

example for other national standard-setters in Europe which are concerned with the risk reporting requirements according to the Modernisation Directive. The need for a risk reporting standard further emerges from the Transparency Directive 2004/109/EC that requires security issuers to provide risk disclosures in annual and in interim filings.[45] Second, and relatedly, GAS 5 may influence the IASB-project *Management Commentary*, which incorporates risk reporting.[46] The German Accounting Standards Committee that is participating in this project may advocate GAS 5 which are read in connection with GAS 15. However, the Anglo-Saxon liaison partners in the project will lead to a further qualification of the German influence. Particularly, the requirement of disclosing direct forecasts may be seen with critical eye by foreign standard-setting bodies, e.g., those in the US.

An international standard on risk reporting may enhance comparability among entities internationally. At the same time, there is potential for convergence in risk reporting requirements. But even if seen as the forerunner standard in risk reporting the influence of GAS 5 must not be overestimated. Most probably, GAS 5 will have a *de facto* influence on other national standard-setters in the EU. However, the impact on the IASB-project will be mitigated by both the influence of other institutions and the project's broader scope on a management commentary.

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45 See Directive 2004/109/EC of December 15th, 2004, Art. 4(2)(b) and (c), Art. 5(3).

46 See www.iasb.org/meetings/iasb_observernotes.asp for notes on the IASB meeting in June 2005, the status of the project, and the planned Discussion Paper.