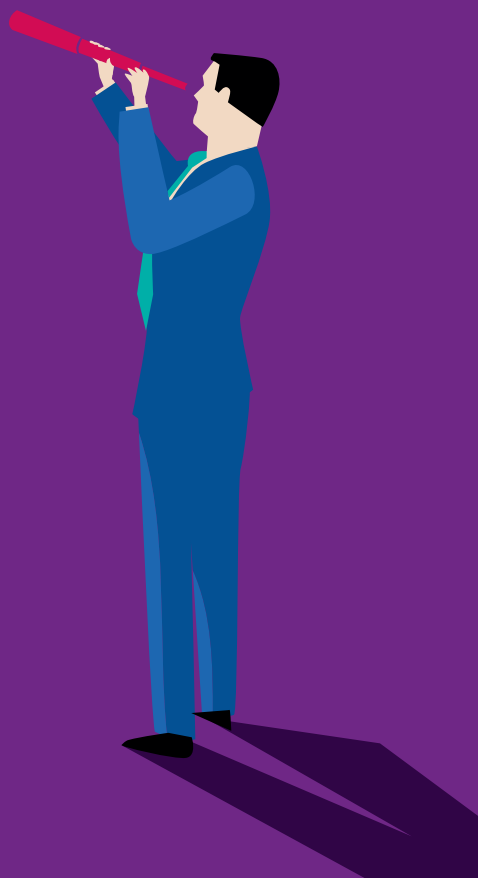
Corporate risk: sharpening the view

Risk reporting analysis
AEX funds



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Introduction

Do we know our risks?

Over the past ten years, it has become increasingly clear that non-financial factors determine the value creation of companies. Success or failure are determined by intangible factors. The power to innovate, the strenght of the brand, the reputation among customers. The number of external factors has steadily grown as we reach limits in a number of areas. Such as nitrogen emissions, climate change, access to water and social inequality. Until a few years ago, most companies considered these factors mainly in the context of sustainability. For sustainability, companies defined what are referred to as the material topics, the social and environmental topics that matter most to stakeholders, because the company has a societal impact on them. Performance and progress were reported separately and the focus was on the longer term.

These topics were not addressed in the standard annual report. In concrete terms, in recent years we found that the most current external risk – climate change – was not included in risk assessment reporting. We also saw that, in general, companies failed to make a connection between material (sustainability) topics and risk management. This raised questions about how companies perceive risks.

An impact is a risk

It has now become clear that the external factors that play a role in the long term can pose a financial risk in an increasingly shorter term. While conducting this survey we were confronted with a pandemic, anti-racism protests and, in the Netherlands, the prospect of water shortages because of increasingly long and dry summers. Long-term external risks can be a significant threat if a company fails to change swiftly or in a timely fashion. Here, the investment and financing horizon is crucial. A company that invests in a product or asset over a period of 20 years must factor in potential changes throughout those 20 years.
The 'sustainability topics' and the financial risks are actually part and parcel of the same thing. This is most clearly seen in the Global Risks Report of the World Economic Forum[1]. Ten years ago, not a single environmental issue and only one social issue (chronic disease) numbered among the top 5. Five years ago, the majority of the top 5 risks comprised economic and geo-political risks. But in 2020, with the exception of weapons of mass destruction, the top 5 will consist solely of environmental and social risks.

Risk reporting should include long-term risks.

[1] The Global Risks Report 2020, World Economic Forum

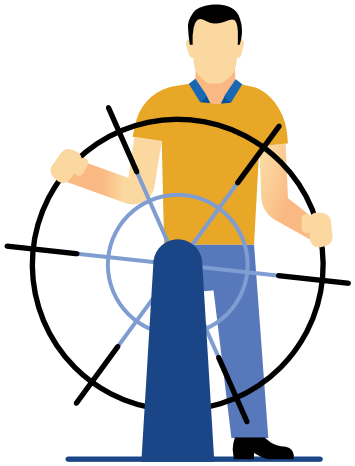
Is the risk section short-sighted?

This led us to wonder whether annual reports convey an accurate view of risks or whether they are 'short-sighted'. A correct (over)view requires a focal point with the capacity to assess the environment as a whole and look far into the future in order to be able to zoom in sharply on the right things or take prompt action to avert potential dangers looming on the horizon.

It is, therefore, vital to evaluate key (anticipated) developments in the area. Not all of these developments will necessarily be imminent, but they can have major impact when they do occur, so it's important that stakeholders are informed of them. To achieve this, it's crucial to take a long-term view and report the risks, since a great many material topics can have long-term effects on the company. In this survey, we performed an analysis of the annual reports (financial year 2019) of the 25 AEX companies[2]. We assessed all categories of risk, not just those related to sustainability.

We have identified almost 450 risks.

To assess whether companies take a short-sighted approach to their risk reporting, we looked at the visibility of the risks in the short and long term, the priorities, and the extent to which the risks are specifically described. This provides insight into the quality of the process and the reporting. To illustrate our findings, we also looked at whether three important and now current developments from the World Economic Forum's Global Risks Report have translated into risk sections: climate change, cybersecurity and the pandemic.



Our four key insights for further improvement

Our survey identified four key insights that can be significantly improved. Overall, when it comes to assessing risks, we see that companies:

- **aren't sufficiently specific in their risk reporting.** The risks don't cover concrete threats – in other words events and their specific impact on the company. We often see that, in their risk reporting, companies identify general risks that could impact any company.
- **focus on short-term risks.** In their risk reporting, companies tend to look at immediate threats, which means that some key risks are underexposed.
- **don't sufficiently connect risks with the material topics.** Defining material topics and risks seem to be separate processes, which leads to non-financial effects that could constitute a financial risk being omitted from the risk reporting.
- **don't clearly prioritise risks in terms of significance and time.** On average, companies report a large number of risks (18), but without clear prioritisation. 40% report more than 20 risks, which are often not ranked by degree of importance (likely impact on the financial value) or long versus short term (partly due to focusing on the short term).

[2] Companies as included in the AEX dated June 30, 2020

Do companies report the right risks: illustration

Based on current affairs and the WEF report we can state (with hindsight) that the four topics mentioned above may deserve attention if you take a long-term view. The WEF report lists climate change as one of the top risks. In their risk reporting, ten companies specifically identify this as an individual risk. Nine others describe it, but do not link it to the risk it poses to their company, or categorise it under another risk. Our own estimate is that climate change poses a risk to almost all AEX funds.

Cybersecurity (criminal breaches, hacks, theft) not only ranks among the top risks according to the WEF Global Risks Report 2020, but also often makes the headlines thanks to successful attacks. All companies indicate that they see this as a risk, although 11 companies categorise it as part of another risk (e.g. IT risk). The question is: does this topic merit specific attention? Seven companies identified a pandemic as a risk. Just like this was stated in the WEF report, this indicates that a number of the AEX funds were aware of this particular risk so it could, therefore, have been identified by the remaining 18 funds.

Risk reporting sometimes isn't sufficiently specific

In essence, the description of a risk comprises a specific event, its potential impact on the organisation and its financial repercussions.

Many of the reported risks are not about threats specific to the organisation. We saw at least some of these generic risks identified by around half of the companies. While those risks may be true and relevant to the organisation, they are written in such a way that they apply to any global organisation and are therefore 'boilerplate', which provides stakeholders with too few insights. Fortunately, there are also many good examples.

Examples of risks not specified identified:

— 'Non-compliance to laws and regulations or the code of conduct can lead to reputational damage.'

— 'The unpredictability of the geopolitical situation requires ongoing attention.'

— 'Not being able to attract and retain the right talent.'

Examples of risks specifically identified:

— 'Risks related to our competitive position. We face significant competition for our drug discovery and development efforts, and if we do not compete effectively, our commercial opportunities will be reduced or eliminated. The biotechnology and pharmaceutical industries are intensely competitive and subject to rapid and significant technological change. Our competitors may develop drug products that render our products obsolete or non-competitive by developing more effective drugs or by developing their products more efficiently. In addition […].'

— 'Rising climate change concerns have led and could lead to additional legal and/or regulatory measures which could result in project delays or cancellations, or a decrease in demand for fossil fuels, potential litigation and additional compliance obligations.'

— 'Regulatory changes related to alcohol. What could happen: The topic of alcohol and health is under scrutiny in many markets. This may prompt regulators to take further measures limiting [our] freedom to operate, such as restrictions or bans on advertising and marketing, sponsorship, availability of products, including health warnings on labels and increased taxes and duties or the imposition of minimum unit pricing. These could lead to lower overall consumption or to consumers switching to different product categories.'

Many traditional generic risks

Most risks relate to traditional topics such as financial, legal and market risks. Together, these three risk topics make up more than 1/3 (39%) of all identified risks, which makes sense as these continue to be key risk areas. However, they should be specific (which event is the exact cause of a financial risk) and in many cases this is not the case.

Examples of generic risks not specified identified:

- Financial risk: 'Company is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than the respective functional currencies of the Company.'
- Legal risk: 'the risk that emerging laws and regulations, agreements, claims, regulatory inquiries or disclosures potentially result in damage to Company's brand and reputation, legal or regulatory sanctions or liability resulting in financial loss.'
- Market risk: 'increased competition from current competitors or new entrants, impacting our ability to maintain and improve our competitive position.'

Cyber security isn't always mentioned as a specific risk

We have identified a key theme such as cyber security as a risk at all AEX companies, with thirteen companies not explicitly referring to this as a risk. The theme has led to more incidents across sectors in the last couple of years. Recently, cyber attacks on Dutch companies resulted in the interruption of business operations. Which strongly suggests that this topic demands specific, targeted attention.

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Companies must describe the risks as concretely as possible, providing an explanation of the *specific events* that trigger a risk and why that event is a potential risk for that organisation.

This will differentiate the risk from those facing other companies. It gives the reader the insight and comfort that the risks have been properly evaluated and that effective risk-mitigation strategies are in place.

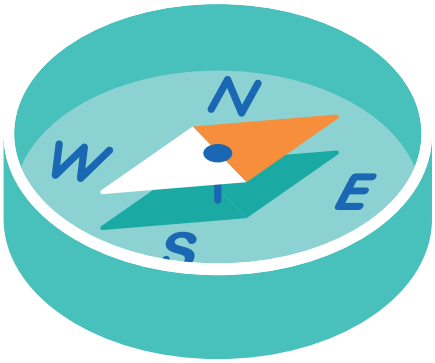
Risk reporting tends to look at the short term

Traditionally, companies look no further than a horizon of one to three years for their risk management. This is based on the reasoning that it will be more difficult to make reasonable estimates of the probability and financial impact of the developments in the more distant future.

There is no insight into the timeframe

Of the 445 risks identified,16 (4%) were explicitly linked to the long term. An example of this is ABN AMRO. For each risk, this bank clearly states whether the risk might occur in the short (0-2 years), medium (2-5 years) and / or longer (more than 5 years) term. Moreover, a distinction is made between risks and opportunities, broken down by strategic priority.

Most companies, 19 out of 25, do not explicitly describe the time frame in which they assessed the risks. This keeps the reader in the dark about the time frame used for the risk overview.



Long-term risks are no less important

To a limited extent reporting includes potential risks that may occur in the longer term, yet this doesn't mean that long-term risks are necessarily less important. In the case of chronic longer-term risks like climate change or innovation, the company will need to prepare. And adaptation might take time because reshaping the business model, investments or talent to address the risks doesn't happen overnight.

The potential risks may also be major, sudden events – acute risks that don't seem important enough in the multiplication of probability x impact, but which, if they occur, are hugely disruptive. This certainly applies to very low frequency incidents such as an explosion, a pandemic or a flood.

Examples of long-term risks:

- 'Trade wars, de-globalisation and protectionism'.
- 'Increased competition from actors with more innovative business models or ability to evolve more quickly (including BigTechs and FinTechs)'.
- 'Exposure to climate, social or ethical risks'.

Pandemic seen by a quarter

The COVID pandemic appears to have taken the world by surprise. The risk of a pandemic is extremely difficult to estimate, and the chance of it happening is extremely small given the very low frequency with which pandemics have occurred historically. The disruption they cause is devastating. In terms of impact, the WEF report lists public health issues as one of its Top 10 risks over the next ten years.

Seven companies identified a pandemic as a risk. Like the WEF report, this indicates that a number of the AEX funds noticed the risk and could have been identified therefore by other companies too. Granted, we're describing this in hindsight, but it is mainly an illustration of the kind of long-term risks that can occur, which investors need to be aware of.

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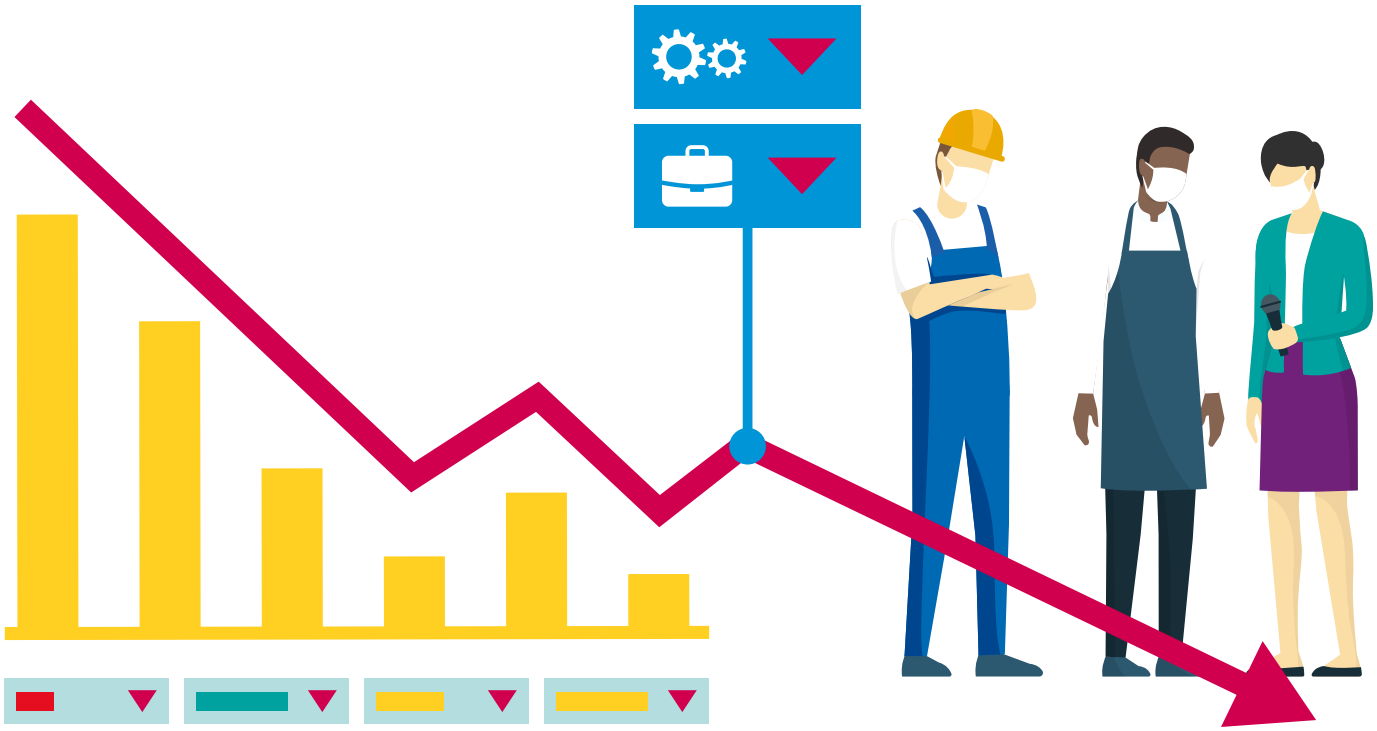
Focusing primarily on short-term risks doesn't provide sufficient insight. The company can deliver more effective and timely insights if it also takes the medium and long term into account.

Obviously, estimating the probability and impact of risks in the long term is a challenge. The first key step is to evaluate the impact rather than the likelihood of the incident: if the company could run into serious problems due to a development / event, this may need to be reported. Scenario thinking can help with this.



Risks insufficiently linked to the material topics

There is no linkage between the materiality analysis and the risk analysis. The survey shows that most companies (18 out of 25) see the process of determining the risks and the process of reporting the topics that are important to broader stakeholders as separate. From the descriptions of the processes, as well as the differences in the terms used, we see that this is generally the case.

Linking the processes ensures that a more complete picture can arise of the material topics that may also constitute a financial risk. Since that isn't the case here, there is a chance that the material topics mistakenly fail to be included in the risk section or, because different terminology is used, it appears to relate to an entirely different topic. Our advice is to focus on the longer term, not just the current timeframe.

Material topics can also be a risk - and vice versa.
All companies have their own way of describing their risks. We have analysed the extent to which the material topics also recur in the risk reporting. Notably personnel, health and safety issues and environmental issues are mentioned far more often in the non-financial / sustainability section of the report than in the risk reporting.

Reputation is also more often listed as a material topic than as a risk. In terms of risks, IT risks (including cyber security and data protection) are mentioned more often than they are listed in the material topics for stakeholders. However, because of their social implications, insights into risks of this kind could be of value to stakeholders.

Of course, the estimates that companies arrive at stem from both processes but the differences show that it makes sense to interlink the two – this way, it's clear that the material topics have been thoroughly assessed as to whether they also pose a financial risk and vice versa.

Climate change on the right track

Climate change is one of the long-term effects of economic activity that requires timely action, and a risk that brings physical effects, which we are now starting to experience. The World Economic Forum[3] has identified climate risks in 2020 as the most relevant risk for companies. And with this, they require specific attention.

Half of the reports describe climate change as a material topic for stakeholders because of the company's impact on the environment.

Ten companies explicitly mention topics related to climate risks as isolated risks in their report, 14 companies indicate that they have taken note of the recommendations of the Task Force on Climate-Related Financial Disclosures[4] and will follow them or are already doing so. 19 companies mention climate change in the annual report, although in many cases they do not identify it as a risk.

This means that AEX companies are on the right track by addressing these risks. We estimate these risks are key to virtually every company, and thus expect them to be more extensively reported.

Top 10 Material topics

- **Personnel**
- **Customers**
- **Compliance and integrity**
- **Governance**
- **IT and information security**
- **Product safety and quality**
- **Climate change, energy transition**
- **Environment**
- **Human rights**
- **Financial performance and risk**

Top 10 risks

- **Financial risk**
- **Legal compliance and reporting**
- **Market risk**
- **Operational risk**
- **Macro-economic, political**
- **Personnel, health & safety**
- **IT, Data protection/quality**
- **M&A, In-/divestments**
- **Innovation, intellectual property**
- **Environmental & safety risk**

[3] https://www.weforum.org/press/2020/01/burning-planet-climate-fires-and-political-flame-wars-rage

[4] The Task Force on Climate-related Financial Disclosures was established by the Financial Stability Board and has developed a framework to report on climate-related risks and opportunities. See www.fsb-tcfd.org

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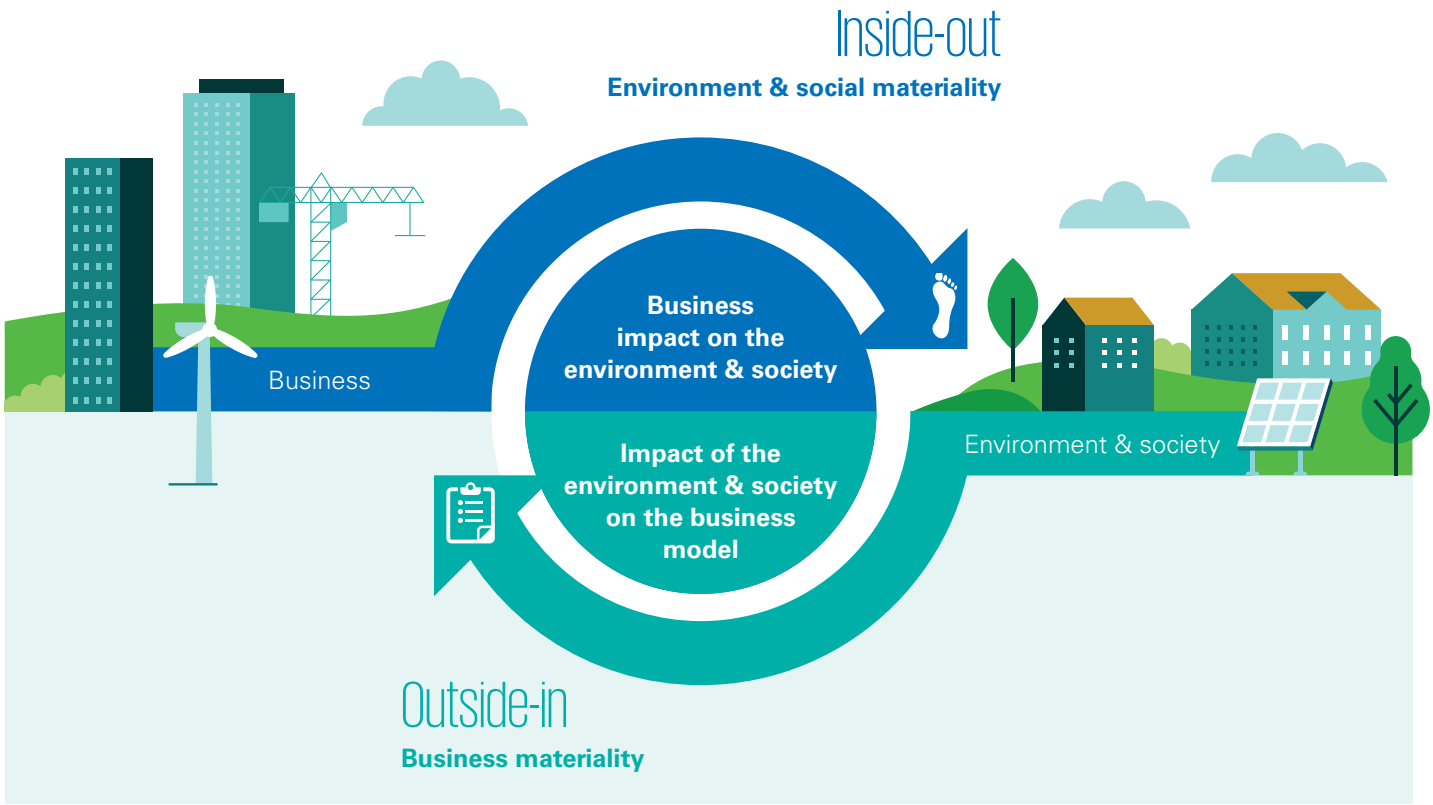
Defining materiality for stakeholders and risk management are two sides of the same coin. The material topics are not only vital for good responsible entrepeneurship but, in the long term, will always translate into a financial risk (or opportunity).

It is confusing to see different overviews of themes in the report that overlap when it isn't clear why it's a key topic but not a financial risk, and vice versa.

We therefore advocate the full integration of both processes and the uniform formulation of the topics so the organisation has a holistic view of risks and opportunities in the short and long term.

This is also in line with EU guidelines, which encourage companies to apply '*double materiality*': defining key topics for the company by looking at the combined effects produced *by the company* (inside-out) and effects *on the company* (outside-in).



Risks are insufficiently ranked according to significance and time

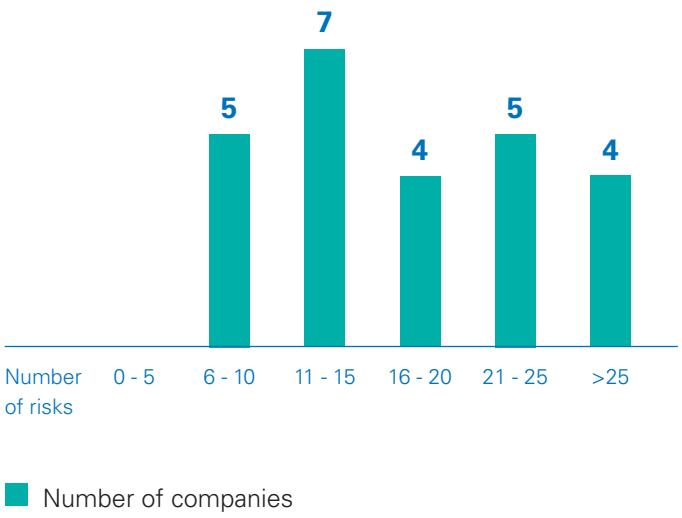
Lack of insight into priorities

We see that companies report an average of 18 risks, ranging from a minimum of eight to a maximum of even 38 risks. Ten of the 25 companies report twenty or more risks.

The number of risks varies per sector. The Oil & Gas sector (average 29 risks per organisation) and Semi-conductor & Industry sector (23) report significantly more risks than the Consumer goods (13) and Financial services (15) sectors.

If a company reports a large number of risks, the question is whether the user (investor) still has an overview of the relative importance of each of the risks.

It appears that the AEX companies prioritise the risks to a limited extent. Nor do companies describe the importance of the risks, i.e. a ranking or the relative magnitude of the risk. This means that investors have no idea which risks are truly important.



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Too many risks - without prioritisation - means that users don't have a clear picture of which risks the organisation should focus on. To pinpoint that focus, the number of risks described should be limited to 10 to 15 risks.

Risk prioritisation provides valuable information, indicating when they may occur (on a timeline) and ranking the risks or giving a risk score indicating their relative importance provide valuable information.

The next steps for businesses

Our research shows several things to address in the analysis and reporting of risks by companies.

We give you a number of core recommendations:

Make the link between long-term developments and financial risks for the company and define and show the risks split into short, medium and long term.

Long-term risks are even more difficult to estimate than short-term risks. For the long term, emphasize the impact rather than the opportunity and think in scenarios: what would happen to the financial value of the company if a particular trend or event actually occurred along different lines.

For example: how might the company's value be affected if global warming is limited to 1.5 degrees compared to how it might be affected when the earth warms by another 4 degrees or more.

This way, by giving a name to the uncertainty associated with the risk, you can shed light on the possible impact of, in this case, climate change.

Integrate defining materiality and risk management in a single process using the 'double materiality' approach and describe them in the report in one chapter.

Approach the process of 'double materiality' as a continuous process rather than an (x-)annual exercise so that you can pick up on changing risks at an early stage.

How can KPMG help?

KPMG is experienced in applying the double materiality approach and integrating the materiality process with the risk management process.

We also have an excellent perspective of the long-term external developments that could affect your future financial performance and can link these to your company in a structured manner in order to map the risks.

Based on our experience with climate change, we have developed a scenario analysis that can anticipate how your company will perform under different climate scenarios.

In the field of risk management, our Enterprise Risk Management team has many methods and tools, including the Dynamic Risk Assessment method, which maps the key risks and their interdependence. We link those risks to business objectives and support the organisation in risk monitoring.

And, of course, we can assist you with drawing up effective reports on the risks and material topics within the regulatory framework.

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