

# From risk reporting to uncertainty communication in financial markets

*Presentation at the M2D conference*

*Isaak Newton Institute for Mathematics, Cambridge*

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# My project

**M2D**: The EPSRC/ESRC  
“*Models to Decisions*  
(*M2D*): *Decision making*  
*under uncertainty*”  
research network

# M2D

Models to Decisions

## Embedded Research Projects

PROJECT PI	TITLE	INSTITUTION	MORE INFORMATION
Ekaterina Svetlova	Communication of uncertainties about company's future to capital markets	University of Leicester	<a href="#">Read more</a>

Three central themes of the network:

Uncertainty Quantification  
From Model to Decision

Communicating Uncertainty

Start date: 01/01/2018

End date: 31/06/2018

# Agenda

- The problem description
- Empirical materials and methodology
- Core findings so far
- Suggestions how to improve uncertainty communication

# Problem description

## Companies



CEOs, CFOs, IR,  
risk management

**RISK DISCLOSURE**

**ANNUAL REPORT /  
the principal risks  
section**

## Capital markets (decision makers)

Fund managers

Securities analysts

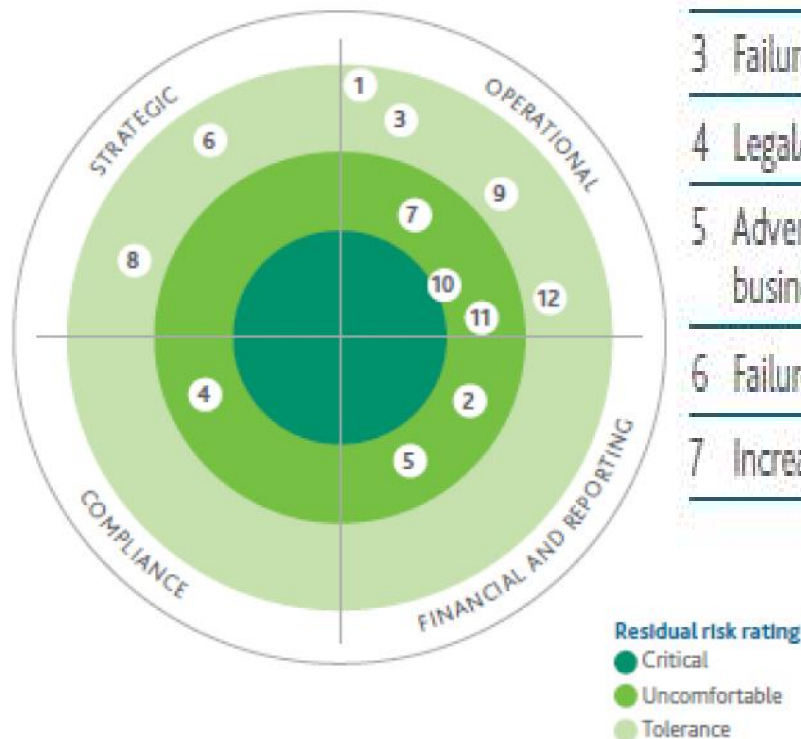


# The problem description

**CURRENT ASSESSMENT OF PRINCIPAL RISKS** in Risk Management and Governance section

## CURRENT PRINCIPAL RISK CATEGORIES

- |   |   |
|---|---|
| 1 Significant failures in internal systems of control | 8 Adverse changes in national, international political landscape    |
| 2 Lack of corporate financial stability               | 9 Operational issues leading to reputational risk                   |
| 3 Failures in information security controls           | 10 Operational IT risk  |
| 4 Legal/Regulatory risk                               | 11 Failure to effectively manage Group's talent and human resources |
| 5 Adverse financial/business performance              | 12 Weaknesses in acquisition and contracting life cycle             |
| 6 Failure to innovate                                 |   |
| 7 Increased internal business complexity              |   |



Source: Capita plc annual report 2016

# Problem description

## Principal Risks

### Strategy key

- Achieve Scientific Leadership
- Return to Growth
- Be a Great Place to Work
- Achieve Group Financial Targets

### Trend key

- Increasing risk
- Decreasing risk
- Unchanged

Risk category and Principal Risks	Context/potential impact	Management actions	Trend versus prior year
<b>Product pipeline and intellectual property</b>			
Delivery of pipeline and new products	The development of any pharmaceutical product candidate is a complex, risky and lengthy process involving significant financial, R&D and other resources. A project may fail or be delayed at any stage of the process due to a number of factors, which could reduce our long-term growth, revenue and profit	<ul style="list-style-type: none"> <li>&gt; Prioritise and accelerate our pipeline</li> <li>&gt; Strengthen pipeline through acquisitions, licensing and collaborations</li> <li>&gt; Focus on innovative science in three main therapy areas</li> </ul>	
Meet quality, regulatory and ethical drug approval and disclosure requirements	Delays in regulatory reviews and approvals impact patients and market access, and can materially affect our business or financial results	<ul style="list-style-type: none"> <li>&gt; Quality management systems incorporating monitoring, training and assurance activities</li> <li>&gt; Collaborating with regulatory bodies and advocacy groups to monitor and respond to changes in the regulatory environment, including revised process, timelines and guidance</li> </ul>	
Secure and protect product IP	Discovering and developing medicines requires a significant investment of resources. For this to be a viable investment, new medicines must be safeguarded from being copied for a reasonable amount of time. If we are not successful in obtaining, maintaining, defending or enforcing our IP rights, our revenues could be materially adversely affected	<ul style="list-style-type: none"> <li>&gt; Active management of IP rights and IP litigation</li> </ul>	Increased number of patent litigation suits alleging patent infringement filed against AstraZeneca by research-based pharmaceutical competitors. Details of material patent litigation matters can be

Source: AstraZeneca annual report 2016

# Problem description

## **Drawbacks of the current practices of risk disclosure:**

- Risk disclosure lacks uniformity and clarity
- It is too broad and too generic and thus does not provide a detailed enough description of risk and uncertainties **(information inadequacy)**
- The quantity of risk information available to investors increased but not the quality **(information overload)**
- No time scale; back-looking
- Risks are **seldom quantified**
- Risk reporting as **the formal box-ticking exercise**

# Problem description

## **Drawbacks of the existing research on risk disclosure:**

- **Focus on the usefulness of the risk information**
- **... for separate groups of market participants**
- **Risk disclosure is limited to written narratives in annual reports**
- **Methodology: content analysis (counting words)**



# The problem description

RISK  
DISCLOSURE

≠

Uncertainty  
communication

RISK

≠

UNCERTAINTY

Asymmetric  
information

≠

Symmetrical  
ignorance

*Financial Models and Society*  
(2018), Edward Elgar, by E. Svetlova.

# Problem description

## Companies



CEOs, CFOs, IR

**UNCERTAINTY**  
(fictional expectations/  
convincing narratives)

## Capital markets

Fund managers



Company reports



Securities analysts



# Problem description

## Companies



CEOs, CFOs, IR

Holistic communication  
Best practice

## Capital markets



Fund managers



Company reports



Securities analysts



# Explorative empirical materials

- **Semi-structured interviews** (n=5) with investor relations and company representatives and (n=27) with portfolio managers/analysts
- Participation in the **IR best practice workshop** in London
- **Informal conversations** with Financial Reporting Council and Invicomm on uncertainty communication
- **Written documents:** annual reports; transcripts and webcasts of the quarterly and annual earnings conferences with investors (available online)



## Two case studies:

1. A start-up within a global engineering company
2. A global pharmaceutical company

# Some findings

- Companies **don't differentiate** between risk and uncertainty; the terms are used interchangeably (e.g., Brexit or climate change)
- Risk is very **negatively connotated** (risk vs. opportunity)
- Risk replicates only **the downside potential**
- Thus, companies **keep risk disclosure to the minimum** (not mention risks if not explicitly asked etc.)
- **No information about time horizon** of particular risks

## Some findings

- **The dialogical/ polyphonic character of uncertainty communication**
- **“Front-stage” and “back-stage”**
- **“Impression management” vs. “bullshitting” (Frankfurt 2005)**
- **More than monetary incentives (friendship, collegiality, theatricality)**

The **company** produces certainty;  
**analysts** perform themselves as professionals;  
analysts accept “no-answers” (relationships/ friendships)  
→ **business as usual; conventions**

# Suggestions how to improve uncertainty communication

- To require companies to present **uncertainties** (upside and downside)
- To establish **the quality criteria** for uncertainty communication (e.g., 5 criteria for effective communication of uncertainty **in science**, Nano-technology in Gavankar et al. 2014)
- To make companies to communicate the results of their **internal stress-testing**
- To **visualize** short-term risks and long-term uncertainties in a picture (e.g., a forward-looking EPS bridge with ranges?) + visualize the interdependencies between risks



Investors don't like  
uncertainty.

Kenneth Lay (Enron)

quote-ency

**MANY THANKS FOR YOUR ATTENTION!**

**QUESTIONS? COMMENTS?**