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# Coping with Uncertainty and Risk in Financial Reporting

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# Differentiating uncertainty from risk

- Uncertainty is represented by the *shape of the distribution* of possible outcomes; it is an attribute of the economic phenomena
  - Uncertainty is represented by variability in the potential outcomes and differences in their likelihood of occurrence
- Risk represents the compensation demanded by market participants for taking on uncertainty; it is an attribute of the market participants
  - Risk averse market participants seek compensation for negative skewness (downside variability) in the distribution of uncertain outcomes
- Queries
  - Should financial reports reflect both uncertainty and risk?
  - If yes, how and can it be done well?

# How has uncertainty been reflected in financial reporting?



- Through recognition thresholds
  - Limit recognition of an asset or liability in financial statements to those that are probable, reasonably possible or more likely than not to occur
    - Addresses uncertainty by not recognizing in financial reports assets or liabilities with lower likelihoods of occurrence
    - Introduces bias against reporting lower probability uncertain amounts that misrepresents the potential effects on the entity of outcomes that are uncertain
      - Issue is exacerbated when there are significant nonlinearities in potential outcomes
  - Common approach in financial reporting in presence of uncertainty

# How has uncertainty been reflected in financial reporting, continued?



- Through measurement
  - By reflecting uncertainty in outcomes in point estimates by reporting expected values (mean) or best estimates (may be consistent with the mode) of uncertain outcomes
  - However, both of these measures provide no indication about the shape of the uncertain distribution, limiting the information provided about uncertainty
  - A mean measure incorporates fully all uncertain outcomes in its probability-weighted measure of central tendency
    - However, it also can provide a misleading entity wide measure about the expected value of uncertain outcomes unless diversification effects/statistical dependence are reflected in the reporting

# How has uncertainty been reflected in financial reporting, continued?



- Through disclosure
  - Measurement uncertainty analyses (reflects uncertainty in recognized measures by disclosing potential ranges in reported amounts if different feasible inputs or measurements were used)
  - Forward looking measures of risks and opportunities (reflects potential *uncertainty* in future asset or liability values due to outcomes differing from those currently expected)
  - Challenges to the usefulness of these measures
    - Difficult to aggregate meaningfully at an entity level due to
      - Diversification effects
      - Statistical dependence (which may change rapidly over time; negative correlation changes to positive in presence of black swan events)
    - Can investors use this information in their models?

# How has uncertainty <u>and</u> risk been reflected in financial reporting?



- Through selection of measurement attributes
  - Fair value measurements
    - Reflect on a timely basis changes in market participants views about the expected values of *uncertain* outcomes and
    - Incorporate market participants demand for compensation for that uncertainty as reflected in the *risk* premium inherent in the estimated or observed exit price
  - Remeasurements of estimated costs in historical cost model
    - Reflect on a timely basis management's estimates of changes in *uncertain* costs (using best estimate or expected value) and
    - Incorporates *risk* effects if estimated costs are discounted
      - However, the risk in the discount rate often has not been well calibrated to the uncertainty

# How has uncertainty <u>and</u> risk been reflected in financial reporting, cont'd?



- Through hedge accounting by changing the accounting for the derivative or hedged item so that the effects of changes in underlying rates or prices on the derivative and hedged item are recognized in income in the same period
  - Hedge accounting reflects the effects on income of the uncertainty being managed (*risk* is incorporated in the measures only through the risk premium)
  - The effects of uncertainty not being managed are not reported in current income, thereby providing only incomplete insight about the uncertainties faced by the entity
    - It may only be cost effective to manage uncertainty that is well understood because it is only that form of uncertainty for which the costs of derivatives are not prohibitive
      - This means that we may receive little insight through hedge accounting into the biggest uncertainties faced by the entity
      - So does hedge accounting really benefit investors? Or does it provide a misleading perspective suggesting the most important uncertainties are being managed?



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# Conclusions



- Policy makers should consider whether and how financial reporting reflects the effects of uncertainty (and perhaps risk) on the entity as a whole
  - At minimum, financial reporting should not misinform
  - The challenges in doing it well are immense, making this conference timely and useful
- If done in financial statement measurements
  - Uncertainty may best be reflected through probability-weighting cash flow measures
  - Risk may best be reflected in the discount rate
- Additional more granular information on uncertainty and risk can be provided in the footnotes