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# Aligning Enterprise Risk Management into Risk Disclosure of the IPO Prospectus

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**Abstract:** This concept paper aims to review the potential of aligning Enterprise Risk Management (ERM) elements into risk disclosure of the IPO prospectus. This concept paper explores the potential for aligning ERM elements within the risk disclosure section of IPO prospectuses. The paper emphasizes the regulatory requirement of the risk disclosure in the prospectus. It highlights the importance of risk disclosure in investment decision-making. It contends the best practices of risk disclosure in the IPO prospectus for the benefit of investors and also reinforces the issuing company's commitment to effective risk management and corporate governance. By incorporating ERM principles, the prospectus not only improves transparency but also strengthens the issuing company's commitment to effective risk management and corporate governance. The key research objective is to evaluate the integration of ERM into IPO risk disclosures, with particular emphasis on regulatory compliance, investor decision-making, and the enhancement of corporate governance practices. This research endeavors to fill the gap in the literature by enhancing the ERM elements in the existing practices of IPO disclosure.

**Keywords**: *Risk disclosure, Enterprise Risk Management, risk assessment, risk mitigation, investment decision*

## 1. Introduction and Background

In Initial Public Offerings (IPOs), the prospectus is a critical document that serves as a comprehensive guide for potential investors. It provides essential information about the company, including financial statements, business strategy, and details of issuance. Aligning the Enterprise Risk Management (ERM) perspective within the IPO prospectus is fundamental to ensuring that risk disclosures are both accurate and meaningful. This alignment not only aids in investor decision-making but also reinforces the company's commitment to information transparency and prudent risk management. Risk disclosure provides investors with a clear understanding of the risk associated with the IPO. This transparency assists investors in making informed decisions and avoiding misleading information. Detailed risk disclosure allows investors to evaluate the upsides and downsides of IPO investing, which in turn facilitates investors to evaluate potential return on investment.

ERM is a holistic approach to identifying, assessing, and managing risks across an organization. Unlike traditional risk management, which might focus on specific risks in isolation, ERM integrates risk management into the company's overall strategic planning. It emphasizes the identification of risks across all aspects of the business such as strategic, operational, financial, and compliance as well as their potential impacts on the company's objectives.

The integration of ERM into prospectus disclosures ensures that investors have a comprehensive view of the risks that could affect the company's performance, enhancing both transparency and investor confidence. A strong legal framework and empirical validation are necessary for the effective incorporation of ERM into IPO prospectuses. Previous studies have shown that robust ERM practices can improve risk disclosure quality, providing investors with a more accurate understanding of risk exposure (Beasley et al., 2005; Hoyt and Liebenberg, 2011). Incorporating these insights strengthens the credibility of risk disclosures and aligns with best practices in corporate governance. By referencing empirical research, the prospectus can more effectively illustrate the benefits of ERM integration in supporting informed investment decisions and safeguarding investor interests.

## 2. Risk disclosure and capital market regulatory requirements

Regulatory requirements for risk disclosure in IPO prospectuses are crucial for ensuring that potential investors receive accurate, comprehensive, and transparent information about the risks associated with investing in a company. Risk disclosure provides some form of investor protection as it provides investors with the necessary information to make informed decisions. The Securities Commission (SC) of Malaysia has stringent requirements for risk disclosure in IPO prospectus and ensures regulatory monitoring to ensure that the issuing company meets regulatory standards and avoids potential legal issues. The comprehensive disclosure of risks includes a variety of categories, such as operational, financial, and legal risks. These details allow investors to assess the potential impact of these risks on their investments. The purpose is not only to protect investors but also to foster market transparency and trust between the issuing company and its stakeholders. Accurate and thorough risk disclosure is critical to market stability and reduces the likelihood of investors being misled by incomplete or incorrect information.

In a broader context, Malaysia's regulatory framework shares similarities with other markets, particularly in the ASEAN region, but also exhibits distinct differences. While regional markets impose their own set of regulations, the extent of Enterprise Risk Management (ERM) integration varies. Malaysia's maturing ERM framework aims to improve corporate governance and ensure that risk disclosure is aligned with international standards. Malaysia can further enhance investor protection by strengthening its regulatory practices, focusing on the integration of ERM into IPO disclosures. This would support market confidence, reinforce the issuing company's commitment to effective risk management, and promote sustainable corporate governance. By advancing its framework, Malaysia can enhance transparency and accountability, benefiting both investors and the broader financial ecosystem.

Section 236(1) (a) of the Capital Markets and Services Act 2007 states that a prospectus should contain all information that investors would reasonably require, and reasonably expect to make an informed assessment of the merits of investing in the securities and the extent of the risk involved. In addition, Capital Market Masterplan 2 outlines the governance strategies of enhancing product regulation to ensure robust governance in managing risk. A progressive shift from merit assessment to disclosure-based regulation enhances the disclosure of information to investors. The master plan set out for a risk-based assessment process in the establishment of new financial products, whose aim is for greater transparency and assurance to the investors. The process is concentrated on risk assessment and risk mitigation through internal controls and regulatory requirements for disclosures and accountabilities.

Specifically, the SC's Prospectus Guideline requires the inclusion of specific sections dedicated to risk factors. This section must disclose the material risks that could impact the company's operations, financial performance, and the investment's value. The risk factors section outlines risk aspects of the corporation's business operations, financial position, and shareholders' investments in the corporation. The Guideline highlights several requirements among others; similar risk factors should be grouped, and listed in descending hierarchical orders depending on their level of severity. The risk statement should be presented in detail and tailored to the company's specific risks and circumstances.

## 3. Risk and Investment Decision

Risk-return trade-off serves as a basic principle in investment decisions. It suggests a positive relationship exists between risk and return. Investors increase their required rate of return as perceived risk (uncertainty) on the investment increases. Investors would select investments that are consistent with their risk preferences. Some would consider low-risk investments, whereas others wanted high-risk investments.

Investor's risk preference also depends on the investor's lifetime. Individuals in the accumulation phase (early to middle years of working careers) are typically willing to assume relatively high-risk investments in the hope of making above-average returns. Individuals in the consolidation phase (midpoint of careers) are willing to assume moderate risk and may not want to take abnormally high risk. Individuals in the spending phase (retirees) prefer to have a less risky portfolio.

Investor's lifecycle determines appropriate investment goals, commensurate with a certain level of risk. Near-term, high priorities are shorter-term financial objectives such as funds for a house down payment or vacation trip. Thus, low-risk investments (fixed-income securities) are considered suitable for achieving those financial objectives. Long-term, high-priority goals include financial independence and the ability to retire at a certain age. Due to their long-term nature, higher-risk investments (equities) can help meet these objectives. Lower priority goals involve desirable objectives but are not critical. For example, luxury vacations, redecorating the home, or a new car every few years. Thus, a combination of risky and less risky financial assets may satisfy the financial objectives.

## 4. Aligning Enterprise Risk Management in the Risk Disclosure

Enterprise Risk Management (ERM) is defined as a process by the Board of Directors, management, and employees, establishing a strategy for the company, identifying potential events (risk) that could affect the company, and managing risks aligned with the company's risk profile, to provide reasonable assurance towards achieving company's objectives (COSO, 2017). Meanwhile, ISO 31000:2018 defines the risk management process as "coordinated activities to direct and control an organization about risk". It also defines the risk management framework as "a set of components that serve as the foundations and organizational arrangements for designing, implementing, monitoring, reviewing, and continuously improving risk management throughout the organization."

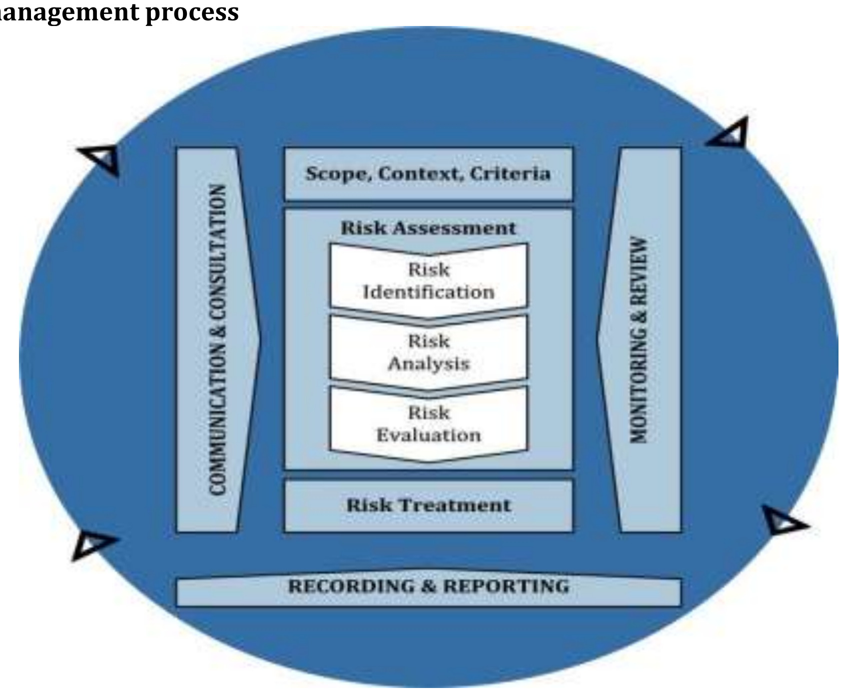
Investors need to perform risk evaluation by analyzing the potential loss or volatility that aligns with their risk preference and financial goals. The propensity of investors to invest should be focused more on managing risk rather than on managing return. Thus, risk drives return. Prospectus serves as a platform for communicating the company's approach to risk management and how it integrates with the overall business strategy. A robust ERM framework presented in the prospectus can highlight the company's proactive approach to risk mitigation and strategic foresight.

Previous empirical studies have demonstrated a connection between Enterprise Risk Management (ERM) and the financial reporting process. Cohen et al. (2017) in their seminal work, highlighted a strong link between ERM and financial reporting. Shad et al. (2019) proposed an integrated approach, combining ERM implementation with sustainability reporting to assess its effect on business performance. However, more empirical evidence is needed to draw a general conclusion (Anton and Nucu, 2020).

The prospectus should outline the company's risk management practices and strategies. This includes how risks are monitored, the roles and responsibilities of the risk management team, and how the company plans to mitigate or manage these risks. The IPO prospectus should focus on the quality and consistency of risk disclosures. The prospectus should provide clear, specific, and quantitative risk information that is material to the investors.

The following Figure 1 illustrates the risk management process under ERM practices. The risk management process involves systematic application of policies, procedures, and practices into six elements of the risk process namely establishing the context, assessing, treating, monitoring, reviewing, as well as reporting. Risk disclosure of the IPO prospectus should be focused on risk assessment and risk mitigation (treatment).

**Figure 1: Risk management process**




Source: ISO 31000:2018

Aligning ERM with IPO prospectus is crucial to ensure investor confidence and transparency. A well-aligned ERM perspective ensures that the risk disclosures are comprehensive, coherent, and reflective of the company's actual risk management practices. This transparency builds investor confidence and can reduce perceived uncertainty. The risk disclosures in the prospectus must be aligned with the company's strategic objectives. The ERM perspective should reflect how the company's risk management practices support and enable its strategic goals. This alignment helps investors see the connection between risk management and business success. Risk management practices in the context of should align with the company's overall business strategy.

## 5. ERM-Based Risk Disclosure

Information on risk management is non-financial information that is strictly necessary for investors (Faisal et al, 2012). The lack of non-financial risk information can cause investors to make poorly informed decisions during the investment process (Abdullah et al., 2015). Grover and Bhullar (2021) claim there is a scarcity of relevant risk categories disclosed to the public through IPO risk disclosures and further argue for the paucity of empirical research to provide evidence on the influence of risk disclosure in IPO performance. Ng and Lee (2019) conclude that there is insufficient risk information in the prospectuses of Malaysia, suggesting that Malaysian company management would not be willing or able to provide the public with accurate and pertinent information through an IPO prospectus. These findings shed into the limelight the need to engage with international standards ( ERM) in the context of the IPO prospectus.

Aligning ERM into an IPO prospectus involves a comprehensive and transparent view of risk management practices. The scope of risk disclosure that needs to be included in the prospectus includes risk identification, risk assessment, and risk mitigation. Risk identification describes how risks are being identified across various areas of the business. Common risk categories include financial, legal and compliance, operational, project, reputational, strategic, and technology. Risk assessment involves the evaluation of risks in terms of their potential impact and possibility of occurrences. Risk mitigation includes details of risk control to reduce the likelihood of occurrences and potential disasters. Overall, risk disclosure in the prospectus is part of risk reporting to the potential shareholders of the company.

Risk disclosure in the IPO prospectus should also outline the risk mitigation strategies. This is to ensure that the identified risk can be managed properly and effectively. A well-structured risk mitigation plan may reduce the likelihood of the risk occurrences and the impact of those risks. A risk mitigation plan enables investors to prepare for due diligence before investing in the IPO potentially leading to more accurate company analysis and evaluation. It also enables investors to make informed investment decisions. Furthermore, a risk mitigation plan may demonstrate a company's transparency and commitment to address the risks, thus reducing the perception of uncertainty that eventually builds trust with investors.

The SC has published a section called Prospectus Exposure on its website to seek comments from the public. The risk disclosure (risk factors) is specifically assigned under a specific section in the IPO prospectus. The risk factors are categorized under three categories namely risk relating to business operations, industry, and shares issuance. However, a mitigation plan for each risk disclosure is in vain.

**Conclusion**

Aligning the Enterprise Risk Management perspective with the IPO prospectus is a critical component of successful public offerings. It ensures that risk disclosures are comprehensive, transparent, and aligned with the company's strategic objectives. By adopting best practices and addressing potential challenges, companies can enhance investor confidence, meet regulatory requirements, and ultimately support a successful IPO process. This alignment not only benefits investors but also reinforces the company's commitment to effective risk management and corporate governance. The above discussion sheds light on a new research agenda to align ERM into the risk disclosure of the IPO prospectus. The future endeavor may look into the potential of aligning the risk management process in the IPO prospectus.

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