The risk in risk factors

Risk factors in issue prospectuses run into 10-12 pages. The investor is drowned with information, but starved of knowledge

Company-specific risks and negative information about the company are either not disclosed or buried

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Back in the nineties, issue prospectuses and advertisements used to play up the highlights of the issue. Laced with superlatives, and often making false claims, they made each issue appear like a red-hot investment opportunity. The regulator decided to bring sanity in such disclosures. It replaced 'issue highlights' with 'risk factors' -- the risks an investor faces if he subscribes to the issue.

Too many, but...

However, like issue highlights, even risk factors have gradually become a joke -- and are actually doing a disservice to investors. On the first page of a prospectus is given a cautionary message: "Investors are advised to read the risk factors carefully before taking an investment decision in this issue." But read how much and what?

The risk factors typically, run into 10-12 pages of a prospectus. How superficial this exercise has become is illustrated by the fact that many risk factors are simply cut-and-paste material, appearing in identical language in most prospectuses. The critical risks specific to the business and negative information about the company are not disclosed adequately.

Whatever little is disclosed is buried in the maze, with the implicit intention of escaping the investor's eye. An analysis of some recent issues shows that outstanding litigation appeared as risk factor number 13, defaults in payment of term loans number 14, qualification of accounts by the auditor number 22, criminal proceedings for claims aggregating over Rs 100 crore number 16.

If a Rs 100 crore claim on a company makes it only at number 16, the 15 risk factors preceding it must be equally, if not more, important. I can't recall a single case -- and I have seen more prospectuses than most -- where they have been. In all cases, they were preceded and followed by general, completely irrelevant, risk factors, which smart promoters and smarter merchant bankers and lawyers have, through their explanation of each risk factor (or what is called 'management perception'), have converted into issue highlights!

...too few of use

Going through issue prospectuses, I have identified scores of such specimens, enough fodder to fill my column for the next six months. But since my parsimonious editors have forced me to tell my piece here and now, I have selected only a small sample of risk factors -- from the innocuous to the irrelevant, from the absurd to the amusing -- that illustrate the racket risk factors have become.

- "Terrorist attacks or other acts of violence would adversely affect the Indian economy, the health of which the company's business depends upon." Or "If communal disturbances or riots erupt in India, the Company's business activities may be adversely affected, resulting in a decline in the Company's income." Useless -- everybody knows that.
- "Being majority stakeholders, the promoters have the ability to exercise significant influence over matters requiring shareholder approval." First, this is commonplace in India. Worse, the company turns this into a virtue, through the management perception: "The company operates in an open and professional manner. The board of directors, on a joint consultative basis, takes important corporate decisions."
- "We are promoted by first generation of entrepreneurs and the investors will be subjected to all consequential risks." The issuer's response "We are in this industry for the last 20 years and are supported by a team of professionals and experts." In the first place, I am not convinced by this risk factor. If one inherits a business, however poorly it is run, there is no risk but if a person has set up a business himself and has run it successfully for several years, it is a risk!
- "The company has not paid any dividends" This in fact should be a strength in an IPO as the promoters have not withdrawn money from the company.
- "Intense competition in the market could affect our cost advantages, which could reduce our share of business from clients, and adversely impact our revenues and profitability." How redundant one can get?
- "Timely and easy availability of raw material is essential for the operations of the company. The prices of the raw materials may also change. This may adversely affect our profitability." Management perception: "Raw materials are available in plenty and we, therefore, do not reasonably foresee any hindrances in the timely and easy availability of the same." Why then state this as a risk?

- “Our registered office is not an owned premise.” The regulator obviously believes not owning the premise where the registered office of the company is located is a risk. Surely, this is a hangover of the vanishing companies’ scam of the nineties, when inspections found companies not available at their registered office addresses. It’s hardly a check, as a fraudulent promoter who wants to disappear with issue funds can sell off his office before doing so.

- “Our revenues and profitability are dependent on a number of factors, and may vary significantly from quarter to quarter, which could cause our share price to decline.” What is the company trying to say that is not known?

- “Political, economic and social developments in India could adversely affect our business.” Or “Changes in the Government policies could adversely affect our business.” Or “Any changes in tax provisions may decrease our profits” These add no value to the investment decision.

Schedule of implementation, promoters, employees, competition, client contracts, technological trends… It goes on and on, basically touching on anything that moves. In order to save themselves from litigation, companies are getting law firms to write out the risk factors. The overriding objective is to minimise the risk of being sued, helping investors to make an informed decision is a secondary goal. The investor is drowned with information, but starved of knowledge. So, what started off as a good service to investors has now become a near-redundant exercise. Finally, giving little comfort to investors about the disclosures is this disclaimer on the front page of each prospectus: “Sebi does not guarantee the accuracy or adequacy of this prospectus.”

Is any investor any wiser reading any of these risk factors? There is a need to overhaul this entire disclosure. For one, it may be a good idea to have a chapter on risks related to equity investing. This can be reproduced verbatim by all issuers, and would be of special help to first-time equity investors. Risk factors should be company-specific. All negative information, including those on litigations and defaults, should be disclosed, irrespective of materiality. If we don’t address this area soon, the day is not far when we would be subjected to foresight like: “Delhi has a high rate of road accidents and our CEO may meet with a serious accident, which will hurt the business.”

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Some risk factors that really matter

- Litigations, defaults and non-compliances of importance (past and present) against company or promoter

- Qualifications of accounts by auditors

- Non-recurring/ unusual income and profits>

- Related party transactions and conflicts of interest

- Non-tying up of issue funds utilisation