Lorenzo Neri

RISK REPORTING: DEVELOPMENT, REGULATION AND CURRENT PRACTICE

An investigation on Italian Stock Market

FrancoAngeli

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To my parents

INDEX

Introduction	pag.	9
Acknowledgment	»	13
1. Corporate reporting and voluntary disclosure	»	15
1.1. The informational approach of corporate financial reporting	»	15
1.2. Corporate disclosure and information asymmetry: agency theory and adverse selection	»	18
1.3. Further motivation for voluntary disclosure: manager behaviour	»	22
1.4. Corporate voluntary disclosure: a problem of benefits and costs	»	27
1.5. International studies on voluntary disclosure	»	33
2. Voluntary disclosure and risk reporting: prior literature and international situation	»	36
2.1. Risk information in voluntary disclosure	»	36
2.2. Risk categorisation and risk management	»	40
2.3. The affirmation of risk disclosure and regulation on risk reporting	»	48
2.4. An international review of risk literature	»	57
2.5. Risk reporting in Italy	»	62

3. Research questions, research methodology and sample composition pag. 65
3.1. Research questions: increase in risk disclosure? Correlation between risk disclosure and company characteristics? » 65
3.2. Research methodology » 70
3.2.1. Content analysis » 71
3.2.2. Statistical methods » 80
3.3. Sample Composition » 81

4. Results and comments » 85
4.1. The extent of the Annual Report and MD&A » 85
4.2. The dimension of risk disclosure » 92
4.3. The presentation of statistical results » 106
4.3.1. Univariate analysis » 108
4.3.2. Multivariate analysis » 111

Conclusion » 117

List of Figures, Tables and Graphs » 121

Appendix A » 125
Appendix B » 131

Bibliography » 133

INTRODUCTION

In recent years, alongside compulsory communication, the issue of implementing voluntary communication within firms has become increasingly important.

On this topic, the literature has produced several lines of study of considerable interest. To meet the needs of their stakeholders, listed companies have worked on communication on their ability to generate profits in the medium-long term.

Effective information should therefore communicate future strategic conduct, expected results and, above all, the complex system of corporate risk.

A critical aspect is the correct identification of risks, whether external or internal. For this reason, in analyzing voluntary communication focusing on future information, particular attention will be placed on the issue of risk reporting. After being identified in the literature, this instrument has subsequently been implemented by some standard setters.

The communication of financial risks alone does not produce enough information on the future financial condition of the firm because this is influenced by strategic and operational risks.

The concepts of risk and risk management, in fact, have received ever-increasing attention. The need for effective risk management, internal control and transparent risk disclosure is an important corporate governance principle. Because of recent corporate scandals, corporate governance is high on the agenda of management, legislators and stakeholders.

In England, the Combined Code on Corporate Governance stresses the need for companies to adopt procedures to monitor risk management, and calls for an external communication of corporate risk.

In Germany, GAS 5 states that the information regarding risks is to be presented in a separate section of the report that accompanies the consolidated financial statement.

As for the professional associations, important contributions have been provided by the Institute of Chartered Accountants in England and Wales (ICAEW), which in the late 90's outlined and systematised the concept of this research.

Efficient risk management produces considerable advantages for both companies and their stakeholders. For companies, information on risk is helpful in managing change, reduce the possibility of financial failure, and improving the efficiency and the image of the company towards credit analysts, customers and shareholders. For shareholders and other stakeholders, a good system of risk information is necessary to evaluate the risk profile of a company in order to make correct investment decisions.

In addition, risk disclosure is important in order to minimize the level of information asymmetry between management and stakeholders.

Some authors suggest that it may lead to a more accurate cost of capital and to better financing conditions.

There are several grounds for this study. First, I shall attempt to answer to a call from the Management Commentary released by the International Accounting Standards Board (IASB) and from the Financial Accounting Standards Board (FASB) for research on firm and industry voluntary disclosure practices.

Second, Healy and Palepu[1] identify firms' motivation in disclosing voluntary information as an important question for research. They discuss the importance of examining how financial reporting and firm voluntary disclosure adapt to changes in both the business and capital market environment over time.

There is growing attention to risk issues and an increasing number of academic works on risk disclosure available. The aim of this study is to investigate how Italian listed companies behave about this topic and how they manage the risks they face or will face.

The work analyses companies listed on the Italian Stock market disclosing risk reporting in their annual reports between 2005 and 2009. The

[1] Healy and Palepu (2001).

year 2005 represents the first year of the adoption of the International Accounting Standards (in accordance with regulation EC n. 16/06/2002), and in Italy there was D.Lgs. 32/2007 that imposed implementation of Directive 51/2003/CE that requires the information in the annual report to be enriched. The new art. 2428 asks that in the annual report the management communicate facts and situations that can dampen actual and future performances, so they should inform about the risks and uncertainties faced by the company.

In fact, even if the Italian law is rather vague about risk disclosure requirements, it implies that there should be risk disclosure in the annual report. The modified article 2428 of the Code Law brings Italian legislation in line with the European legislation, which imposes companies to provide an overview of the main risks and uncertainties they face in the annual report.

The sample consists of 143 Italian companies listed on the Italian Market. Considering the segments of the *Borsa Italia*, we have 21 companies for the Mib segment; 36 companies for the Mid segment, 86 for the Small segment, and 5 for the Micro segment.

Based on an examination of the information from Borsa Italiana, I also make a distinction by looking at the different activities of the companies and dividing them into: Basic Material (BM), Consumer Goods (CG), Consumer Services (CS), Health Care (HC), Industrial (ID), Oil & Gas (OG), Technology (TC), Telecommunication (TL) and Utilities (UT).

In order to obtain a measure of risk information, content analysis is performed. This is a method of codifying text into various categories, in this case risk categories, depending on selected criteria.

I developed a software (I called it Bako, "Business Analysis through Key Occurrences") to count the length of full annual reports and all the sections I am interested in and to count the occurrences of words related to risk concept.

In particular, I counted the length of the financial and non-financial risk section inside Relazione sulla Gestione to verify if companies have disclosed more information in this time period.

The total number of risk-related sections and sentences in the annual report is applied to assign a risk disclosure score to each company.

Several hypotheses test whether there are any corporate differences between companies that have a high or low risk disclosure level.

I identified the independent variables and I compared them with the risk disclosure score using univariate and multivariate tests to attempt to find out if there are any differences in company characteristics and corporate governance characteristics between companies that have a high risk disclosure level and companies that do not disclose much risk information.

The reminder of this study is organised as follows. Chapter 1 provides an overview of the economic theories under voluntary disclosure. Chapter 2 illustrates the general disclosure situation about risk. Chapter 3 develops the research hypotheses, describes the research design and methodology, and the sample at the basis of the present work. Chapter 4 describes the matching procedure, presents the descriptive statistics and results of tests.

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1. CORPORATE REPORTING AND VOLUNTARY DISCLOSURE

1.1. The informational approach of corporate financial reporting

The primary aim of entities in publishing annual reports was initially to satisfy the statutory purpose of publishing the annual accounts of the company, and at the same time to inform shareholders about the actions taken by the executive on their behalf and the results of those actions.

Over the last decades, the economic changes due to globalization and technology have brought about changes in the public interested in corporate financial reporting and, inevitably, have influenced the nature and the composition of this document.

The changes in the international business environment have imposed a revision of the nature and content of corporate reporting. Thus, the annual publication of an entity is no longer merely a version of the annual accounts, published to satisfy statutory requirements, but it is now a corporate publication detailing the actions taken by the managers, and their plans for future activities for the benefit of the shareholders of the entity. Indeed, it has been argued that the temporal focus of such reports has moved from a backward-looking emphasis on reporting actions and results to a forward-looking emphasis on the future and the desirability of that future[1].

Corporate financial reporting has become fundamental for management wishing to win shareholders' and creditors' confidence, because it has become an effective means to exercise adequate monitoring and control

[1] On this topic, see Eccles, Hertz, Keegan and Phillips (2001).

over directors' and managers' actions[2]. Above all, it plays an important informational role in the investors' decision process in selecting the most suitable actions among the available alternatives (such as investment portfolios), contributing to the efficient functioning of the capital market. In this way, financial reporting satisfies both the entity's accountability claims and informative and public relations requirements.

The perspective of corporate financial reporting shifted towards an informational approach that, as Beaver highlights, has facilitated a rapid growth in reporting requirements, and changes in the existing ones, with more emphasis on soft data and wider disclosure[3].

This financial reporting evolution can be better understood in the light of the current financial reporting environment consisting of the various groups affected by financial reporting. These groups include investors, intermediaries, regulators, management and auditors with different roles and interests for each of these groups. As a result of this complexity, financial reporting can induce a variety of economic consequences with differing influence on the various clusters, including effects on the following: wealth distribution, resource allocation, risk allocation.

Thus, as Mohanram says, traditional financial reporting mostly provides historical information; moreover, in certain industries, conventional accounting and reporting strategies may not be sufficient to accurately represent the complexity of a firm's operations.

In order to solve the information needs of the actual users, some firms, understanding the limits of the traditional financial statements, engage in voluntary disclosure, described by the Financial Accounting Standards Board (FASB) as "*information primarily outside of the financial statements that are not explicitly required by accounting rules or standards*"[4].

The corporate financial report, thus, becomes a complex document that uses two different types of information to communicate with stakeholders: mandatory and voluntary disclosure.

The aim of mandatory disclosure is to satisfy the primary users' informational needs, ensuring production quality control through the observance of laws and standards. Mandatory disclosure refers to those

[2] Holland (2005).
[3] Beaver (1989).
[4] Fasb (2000).

aspects and information which must be published as a consequence of the existence of some legal or statutory stipulations, capital markets, stock-exchange commissions or accounting authority regulations. So, every characteristic of corporate reporting is regulated at national or even regional level through professional organizations or government authorities, and is practiced in most countries by all the firms regardless of their size, of their judicial, fiscal or national accounting system, preferred finance sources and other factors with impact on disclosure policy[5].

Voluntary disclosure serves to complete the mandatory reporting process that often seems to be inadequate to satisfy a particular user's needs[6].

The entities often voluntarily increase their public information to assure the shareholders of management actions, to obtain capital and also to attract investors, even in the absence of regulation.

Moreover, voluntary disclosure may help the users of financial reporting to better understand or communicate the differences existing between the market and book value of an enterprise.

According to Lev, Guo and Zhou[7], it is possible to identify three major issues on the disclosure of information:

(1) the presumed objectives of disclosure. This issue answers the question, "*why disclose*?";
(2) the determinants of how much and by what means firms disclose. This issue is related to the tension between benefits and costs of disclosure;
(3) the consequences of corporate disclosure. This refers to the empirical findings of the studies[8] conducted on the relationship between disclosure and some quality/quantity characteristics.

[5] Items which define the mandatory character of disclosure are:
− issuer: company;
− receivers: shareholders, employees, creditors, customers and other stakeholders;
− regulations: commercial law, accounting law, accounting standards: IFRS, US GAAP, European Accounting Directives, national accounting standards etc.;
− content: format and object of disclosed statements;
− period of disclosure: annual, biannual, quarterly or occasionally;
− dissemination means: printed or web site.

[6] Regarding voluntary disclosure, there is no generally accepted definition or theoretical background for it.

[7] Lev, Guo and Zhou (2004).

[8] See, for instance, Botosan (1997); Lang and Lundholm (1993; 1996); Sengupta (1998).

This part of our study examines the first two characteristics, while in the subsequent paragraphs, I will underline the consequences of corporate disclosure.

1.2. Corporate disclosure and information asymmetry: agency theory and adverse selection

As stated above, disclosure is critical to the efficient functioning of a capital market[9] because it plays a fundamental role in reducing the information asymmetry between management and shareholders, management and investors, and between different categories of investors.

The issue of voluntary disclosure is linked to the broader information asymmetry theory.

The information asymmetry is a condition in which at least some relevant information is known to some but not all parties involved. Since all the market participants do not have access to the information they need for their decision-making processes, the markets become inefficient.

Better disclosure limits the information asymmetry and mitigates market inefficiency.

In order to understand the principal factors that explain the reasons for disclosure, I shall illustrate the relationship between information asymmetry theory and agency theory and adverse selection as the most important effect of the information asymmetry.

Agency theory is one of the most important economic theories connected with the problem of information between management and shareholders and management and investors. These relationships have been described in terms of the stewardship theory, a broader concept of accountability[10]. Economics literature treats this as a problem of moral hazard concerning agency theory.

This assumption may explain why firms decide to disclose voluntary information in their annual reports.

[9] Theoretical and empirical studies in accounting focus on the information role of voluntary disclosures for capital markets. See Healy and Palepu (2000) and Verrecchia (2001).

[10] Stewardship embodies far more than accountability, most obviously the concept of "responsibility for" which is broader than "accountable to".

In the first place, it is important to describe the principal-agent problem that results from the separation of the ownership and control of the firm.

Principals delegate decision-making authority to agents of the firm as part of the agency relationship between the parties. The delegation of the decision-making authority creates agency problems because the agent may have incentives to increase his own wealth instead of the wealth of the principal.

The separation of ownership and control of the firm results in information asymmetry: the agent is assumed to have access to superior information (private information) and to use them to maximize his own interests at the principal's expense. This is the moral hazard problem which not only includes fraud but also other actions such as risk-reward trade-offs made in project selection[11].

Agency costs are the consequences of information asymmetry, moral hazard behaviour and the conflict between principal and agent.

There are three types of agency costs that may emerge as a consequence of the agency relationship.

The first of these is the *monitoring cost* faced by the owner/principal in an attempt to minimize undesirable agent behaviour. Some examples are the costs of observing and measuring management's behaviour and creating compensation policies based on an increase in the company's wealth. To reduce agency costs, the principal incurs monitoring costs and establishes employment contracts and remuneration arrangements with the agent in order to align the interest of both parties. In any case, the compensation of the agent may be conditioned by achieving certain accounting results.

The second agency cost is the *bonding cost* incurred by the management/agent. Bonding costs are the consequence of monitoring costs. Monitoring costs decrease the value of the agency relationship and consequently decrease the amount of compensation the principal is willing to pay the agent. Bonding costs are defined by Jensen and Meckling as "*the expenditure of resources by the agent to assure the principal that the agent will not act in a manner detrimental to the principal*"[12]. It is important to add that agents choose the least expensive cost between monitoring and bonding

[11] A description of the agent problem is found in Ronen and Yaari (2001).
[12] Jensen and Meckling (1976).