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## Technical Note: Company Risk-related Disclosures in a Code Law Country: A Synopsis

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### Abstract

This synopsis provides a concise historical contextualisation of current risk disclosure issues, highlights major factors influencing contemporary risk reporting practices, and engages in a reflective overview of four recently published papers on aspects of corporate risk-related disclosures in a code law country, Portugal. The breadth and depth of our analysis is modest. Nonetheless we report findings indicating that risk-related disclosures are inadequate, lack transparency, and compound the difficulty of assessing the risk profile of a company. We contend that recent regulation initiatives have been of dubious effectiveness in improving the quality of risk information disclosed. In respect of the Portuguese context, we find that companies disclose risk-related information principally to reduce agency costs and to enhance corporate reputation. We contend that enhanced corporate accountability would be more likely to ensue if further disclosures of relevant risk-related information were mandated. One mechanism to do so would be through regulations recommended by the International Integrated Reporting Committee (IIRC).

### Keywords

Risk, management, disclosures, visibility, reputation, agency, Portugal



# Company Risk-related Disclosures in a Code Law Country: A Synopsis

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## Abstract

This synopsis provides a concise historical contextualisation of current risk disclosure issues, highlights major factors influencing contemporary risk reporting practices, and engages in a reflective overview of four recently published papers on aspects of corporate risk-related disclosures in a code law country, Portugal. The breadth and depth of our analysis is modest. Nonetheless we report findings indicating that risk-related disclosures are inadequate, lack transparency, and compound the difficulty of assessing the risk profile of a company. We contend that recent regulation initiatives have been of dubious effectiveness in improving the quality of risk information disclosed. In respect of the Portuguese context, we find that companies disclose risk-related information principally to reduce agency costs and to enhance corporate reputation. We contend that enhanced corporate accountability would be more likely to ensue if further disclosures of relevant risk-related information were mandated. One mechanism to do so would be through regulations recommended by the International Integrated Reporting Committee (IIRC).

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## Introduction

How and why companies use disclosures in annual reports to communicate their exposure to risk, and their risk management practices, is a matter of considerable public interest. Despite growing attention to risk issues following recent major unexpected corporate collapses (e.g. Enron, Worldcom, Parmalat, Barings Bank) and the Global Financial Crisis of 2008/09, the factors explaining companies' risk-related disclosures (RRD), and the levels and patterns of their RRD, are not well known. Transparent RRD should be an important corporate governance objective.

This synopsis provides a reflective overview of four recently published papers on aspects of corporate RRD – all using Portugal as an empirical setting. Such a setting seems to be warranted and timely given widespread concerns about the affect of risk-related economic behaviors by governments and companies in European Latin countries (such as Portugal, Spain, Italy and France) on global economic stability. This synopsis also provides a concise historical overview of current risk disclosure issues and reports some of the important factors that have influenced levels and patterns of RRD. The findings reported are instructive because most existing research focuses on RRD practices in Anglo-American countries. The insights obtained will help develop better understanding of the economic, social and regulatory context of Portugal – and perhaps (even if only slightly) provide insights into why Portugal is implicated in concerns about global financial stability.

Anglo-American countries have a common law focus. Financial reporting principally seeks transparency and full disclosure. Listed public companies tend to be owned widely. Stock markets are well developed and are the main source of financing. Financial reporting emphasises shareholder rights and investors' interests. Financial disclosure is viewed as a way of reducing information asymmetry between managers and investors. High levels of RRD are expected.

In contrast, Latin countries (such as Portugal, Spain, and Italy) operate under a code law system that is oriented toward legal compliance. Such countries are characterised by low levels of disclosure. This is largely because listed companies are usually family-based and have a high concentration of family ownership. As a consequence, "insider communication solves the information asymmetry between managers and shareholders" (Ball, Kothari & Robin 2000, p3). Stock markets are small. The government and banks are the primary source of financing. Financial reporting focuses on creditor protection (Lopes & Rodrigues 2007). Consequently, in comparison with practice in Anglo-American countries, different levels and patterns of RRD should be expected.

Agency theorists contend that disclosure of risk information is motivated by a desire to reduce information asymmetries between shareholders and managers; and that disclosure of risk information will reduce agency costs (Jensen & Meckling 1976). Monitoring mechanisms, such as ownership structure, board independence, audit committee independence, leadership duality and the quality of external auditors, promote higher levels of information disclosure (Linsley & Shrivs 2005). However, no single theory provides a complete explanation for why companies make RRD. The four studies we discuss later find also that incentives for RRD can be explained by legitimacy theory and a resource-based perspective.

We begin with a brief and concise historical contextualisation of current risk disclosure issues. We then provide a brief synopsis of each of the four empirical studies. We conclude with a reflective discussion that draws attention to the need for further mandated disclosures of risk-related information.

## Historical Perspective

Since the Industrial Revolution risk has assumed a strong presence in management thinking. Fayol (1949) recognised its importance when he advocated *security* as one of six functions of industrial activity. *Security* was conceived as the mitigation of potential risks and safeguarding of property and persons against threats, hazards and the endangerment of business progress.

The concept of risk has evolved from initially only conceiving the negative dimension of risk (or downside risk) to also incorporating the positive dimension of risk (or the upside risk of embracing any future potential opportunities). Early definitions of risk restricted the notion to real world events that were connected to companies' external environments. However, in the face of continually-evolving threats to business activity, there is now a broader view of risk. This broader view recognises the importance of implementing appropriate risk management systems within organisations to foresee threats and to help prevent possible financial distress (Gallati 2003).

To control the systemic risk to which companies are exposed, and to help ensure adequate risk management, regulatory authorities have begun to force listed companies to develop their culture, infrastructure, and organisational processes relating to risk (as we explain below). Since the 1990s there has been a concerted endeavour to regulate risk reporting and to implement risk management systems.

In 1992 in the USA the Report of the Committee of Sponsoring Organisations of the Treadway Commission (COSO)<sup>4</sup> (titled *Internal Control: Integrated Framework*, accessible at <http://www.coso.org/IC-IntegratedFramework-summary.htm>) established guidelines for the design, assessment and improvement of internal control systems. This report aimed to help identify and prevent fraudulent financial reporting. The COSO report regarded internal controls as embracing control environment, risk assessment, control activities, information and communication, and monitoring. The presence of these five elements was thought likely to provide reasonable assurance that a company would achieve effective and efficient operations, report reliable financial information, and comply with laws and regulations (Woods 2008).

There was only a limited adoption of the COSO Integrated Framework by US companies until 2002. In that year, the Sarbanes Oxley Act [SOX], in effect, recommended the application of the COSO guidelines as a suitable regulatory response to the [then recent] financial scandals involving Worldcom and Enron. This recommendation was intended to improve the reliability of financial reporting. It was predicated on the idea that good internal controls would assure reliability. Section 404 of SOX required each company annual report to contain an internal control report in which management assessed the effectiveness of their company's internal control system. However, the increased cost of compliance with this requirement (which shifted most Initial Public Offerings from the US to the UK) prompted the US Securities and Exchange Commission (SEC) in 2006 to publish Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (accessible at <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>), in which it changed its position in relation to COSO. The SEC recognised that the 1992 COSO *Integrated Framework* did not set forth a suitable approach for management to follow in evaluating the effectiveness of a company's internal controls over financial reporting (Woods 2008).

In the UK, risk management issues became prominent from about 1992 with the Cadbury Report on accountability and risk management aspects of corporate governance

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<sup>4</sup> For details of the sponsoring organisations see <http://www.coso.org/>.

(Demirag, Sudarsanam & Wright 2000). However, the Cadbury Report neglected important disclosure matters (for example, of internal controls and risk management practices). In 1999 the London Stock Exchange issued Internal Control: Guidance for Directors on the Combined Code, also known as the Turnbull Report (accessible at [http://www.ecgi.org/codes/code.php?code\\_id=129](http://www.ecgi.org/codes/code.php?code_id=129)). This recommended the inclusion of an appropriate report to shareholders about the evaluation conducted by a company of its internal control system. However, the Turnbull Report did not require that specific risks be explained to help stakeholders properly assess the risk position of a company.

The revisions to the UK Corporate Governance Code in 2010 added a new principle: “the board is responsible for determining the nature and the extent of the significant risks it is willing to take in achieving its strategic objectives” (Financial Reporting Council (FRC) 2010, p7). The Sharman Panel of Inquiry established by the FRC in 2011 to consider Going Concern and Liquidity Risks: Lessons for Companies and Auditors, recommended that the going concern assessment process focus on solvency risks as well as liquidity risks; identify any risks to an entity’s business model or capital adequacy that could threaten its survival; and include stress tests of liquidity and solvency. The new model was required to integrate going concern reporting with discussion by directors of strategy and principal risks (FRC 2011).

The Institute of Chartered Accountants in England and Wales (ICAEW) published Financial Reporting of Risk: Proposals for a Statement of Business Risk in 1997 (ICAEW, 1997). This proposed that listed companies voluntarily disclose information about business risk in a specific statement in their annual report. Companies were to adopt a full disclosure perspective in explaining their significant risk exposures and how those exposures were being dealt with. Risk reporting in this fashion was claimed to be likely to reduce the cost of capital, signal a company’s best level of risk management ability, encourage better risk management, and improve accountability. However, such disclosure did not fully recognise the commercial sensitivity of risk information. In two subsequent ICAEW publications (No Surprises: The Case for Better Risk Reporting in 1999; and No Surprises: Working for Better Risk Reporting in 2002) an opt-out clause was included to relieve companies of the obligation to disclose risk information. In 1988 the Basel I Accord (International Convergence of Capital Measurement and Capital Standards, accessible at <http://www.bis.org/publ/bcbs04a.htm>) issued by the Bank of International Settlements (BIS) sought to reduce systemic risk of companies, enhance market discipline, and assure the stability of the financial system. The Accord established standards for calculating the capital adequacy of finance companies. In 1998, in Enhancing Bank Transparency (accessible at [http://www.bis.org/list/bcbs/from\\_01011996/index.htm](http://www.bis.org/list/bcbs/from_01011996/index.htm)), the BIS proposed that banks should disclose information about their financial performance, financial position, risk management strategies, and risk exposures of all kinds (credit risk, market risk, liquidity risk, operational risk and legal risk). In 2004, the BIS published a revised framework (International Convergence of Capital Measurement and Capital Standards: A Revised Framework) known as the Basel II Accord (accessible at <http://www.bis.org/publ/bcbs107.htm>). This sought to reinforce minimum capital requirements, supervision arrangements, and market discipline.

In 2009, influenced by events of the Global Financial Crisis of 2008/09, the Basel II requirements were revised and renamed the Basel III Accord. The revisions introduced higher capital requirements to compensate for the effects of the credit risks involved with complex trading activities, stressed Value-at-Risk (VaR) requirements as a means of reducing procyclicality, and reinforced disclosure requirements relating to securitisations and off-balance sheet exposures. However, opt-out clauses continued to allow the non-reporting of risks that were regarded as too commercially sensitive or prejudicial.

In the accounting profession, the International Accounting Standards Board issued International Financial Reporting Standard (IFRS) 7 (Financial Instruments: Disclosures) in 2005 (accessible at <http://www.iasplus.com/en/standards/standard47>). IFRS 7 required disclosures of the risks associated with financial instruments. Although companies are subject to *financial and non-financial* risks, the mandatory disclosure requirements of IFRS 7, even after its most recent amendment in 2011, focus only on financial risks (that is, credit risk, market risk, and liquidity risk).

#### Four Studies of Risk-related Disclosure

In Oliveira, Rodrigues & Craig (2011a) we proposed a theoretical framework that combined agency theory, legitimacy theory and resources-based perspectives to explain the motivations for RRD by Portuguese non-finance companies. A content analysis assessed the RRD practices in annual reports for 2005 of 81 Portuguese companies in the non-finance sector (42 listed and 39 unlisted).

We found that adoption of IFRS and the European Union's Modernisation Directive in 2005 did not affect the quantity and quality of RRD positively. RRD were generic, qualitative and backward-looking. Public visibility (as assessed by a company's size and its environmental sensitivity) was a crucial influence in explaining RRD. There was strong evidence that companies managed their reputation through disclosure of risk-related information. The level of RRD increased with higher levels of debt exposure (leverage), and with a greater presence of independent directors.

In Oliveira, Rodrigues & Craig (2011b) we assessed the quality of RRD made by 190 Portuguese Credit-granting Institutions (PCIs) by means of a content analysis of their individual annual reports for 2006. We explored the effectiveness of the reforms of RRD practices that were introduced in 2007 in IFRS and the Basel II Accord. A principal finding was that RRD lacked comparability because they used different maturity time bands to report exposures to credit, market and liquidity risks; different VaR and sensitivity analysis assumptions; and different practices for reporting capital structure and adequacy.

In Oliveira, Rodrigues & Craig (2013) we analysed individual annual reports of 185 PCIs for 2006 to understand *why* finance companies made RRD. We found that some particular characteristics of the banking sector were influential in motivating mandatory and voluntary RRD (e.g., consumer orientation, high levels of public visibility, multiple stakeholders, and intensive regulation). Because the results pointed to the inadequacies of shareholder theory in explaining RRD, we explored whether legitimacy theory and the adoption of a resources-based perspective explained RRD. We found that legitimacy and reputation factors were influential: managers of PCIs with high public visibility attributed greater importance to RRD than did managers of banks with lower public visibility.

In Oliveira Rodrigues & Craig (2011c) we explored factors that affected voluntary RRD in the individual annual reports for 2006 of 111 Portuguese commercial banks. Voluntary operational risk, capital structure and adequacy disclosures were assessed using a list of disclosure categories developed from the Third Pillar disclosure requirements of the Basel II Accord. We found that stakeholder monitoring and corporation reputation were crucial factors explaining the risk reporting practices observed. Voluntary risk reporting appeared to enhance legitimacy by fulfilling institutional pressures to assure the effectiveness of market discipline; and by managing stakeholder perception of a corporation's reputation. Thus, the voluntary RRD observed was explainable by legitimacy theory and resources-based perspectives.

## Discussion

In general, the RRD practices observed in the four Portuguese studies were inadequate. They were vague, generic, qualitative and backward-looking. This lends support to the need for further regulatory initiatives to improve the disclosure of risk information. To date, most risk-related regulations have tended to focus only on financial risks (e.g. IFRS 7) or have demanded vague and generic RRD (e.g. European Directives 2001/65/EC, 2003/51/EC, 2004/109/EC, and 2006/46/EC). Companies should be encouraged to disclose more and better risk information, especially forward-looking RRD. Clearer explanations are needed too – of how risk is aligned with strategy, of how risk is managed, and how all varieties of risk are expected to affect the future performance of a company.

RRD by Portuguese finance companies lacked transparency, making it difficult to assess the risk profile of a company. The adoption of risk-based regulation (e.g., IAS/IFRS and EU's Modernisation Directive in 2005) had a positive effect on the *quantity* of RRD, but not the *quality*. The RRD practices of Portuguese non-finance companies were predominantly backward-looking and qualitative. RRD of highly publicly visible Portuguese commercial banks were usually made in annual reports in risk-specific sections of the management report and/or notes to financial statements. In Portuguese non-finance companies, RRD were scattered throughout the annual reports.

RRD were motivated by more than a desire to resolve problems of information asymmetry. Managers were motivated to make RRD to avoid agency costs and to sustain competitive advantages. They used RRD as a communication strategy to enhance corporate reputation, consistent with legitimacy theory and resource-based perspectives. Public visibility and concerns about corporate reputation were crucial influences in explaining RRD as well.

The presence of independent directors significantly improved the level of RRD by non-finance companies. Thus, corporate governance structure was an important factor in encouraging RRD. The apparent awareness of supervisory and regulatory entities to the failure of boards of directors (in particular of independent non-executive directors) to identify, understand and control risks has been manifest in two initiatives: first, the European Parliament and Council's reinforcement of corporate governance structures (e.g. EU Directive 2006/46/EC); and second, the Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies, published by the EU (accessible at [http://ec.europa.eu/internal\\_market/company/modern/corporate\\_governance\\_in\\_financial\\_institutions\\_en.htm](http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm)).

Integrated reporting presents a possible facilitative way ahead, as the International Integrated Reporting Committee [IIRC] has noted:

The recent global financial crisis has made it clear that risks can develop, be harboured and be transmitted through market participants and practices that fall outside the traditionally prudentially regulated institutions. One important tool in addressing these risks is greater transparency of market participants, which Integrated Reporting can facilitate (IIRC 2011, p23).

Enhanced accountability would seem more likely if further disclosures of substantive and relevant risk-related information in company annual reports were mandated.

How to elicit better accountability by companies of their exposure to risk and their management of risk is a challenging task. Empirical and theoretical understandings of the type elicited in the four studies synthesised here should be helpful in addressing that task.



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