Risk Disclosure Practices in Annual Reports of Listed Companies: Evidence from a Developing Country

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Abstract
Introduction of IFRS 7 by International Accounting Standards Board adds to the quality of risk disclosure practices to be exercises by all preparers of financial statements. It is expected to provide potential investors the opportunity to better evaluate financial risk exposures of entities holding material financial assets and liabilities. Our main objective was to evaluate the quality of risk reporting practices of Macedonian listed entities subsequent to introduction of IFRS 2009 and provide empirical evidence on the state of compliance with IFRS 7 requirements. This paper investigates the factors that influence the quality of disclosures related to risks arising from financial instruments provided by Macedonian listed companies in their financial statements prepared in accordance with International Financial Reporting Standard (IFRS). We have constructed a disclosure index for each listed company based on IFRS 7 requirements. The regression analysis includes variables representing some characteristics of listed companies investigated, such as their size, industry, type of auditor engaged, ownership concentration, profitability and leverage. We have concluded that the level of compliance with risk disclosure requirements is related to the type of auditor engaged and ownership concentration in investigated companies. The research highlighted areas of financial reporting practice that could be improved by most listed companies in order to be fully compliant with IFRS requirements.
Key words: financial risks, disclosure indices, company characteristics

1. Introduction

The purpose of this paper is to study the quality of risk reporting practices in financial statements of listed companies in Republic of Macedonia, a country that uses IFRS as national accounting standards. Since 2009, when last translation and update of IFRS was done for regulatory purposes, little research has been done on the issue of quality of financial reporting practices and company or country-specific characteristics that influence the quality of financial reporting in the country. Several accounting theories provide help in developing hypothesis regarding the factors that determine the quality of reporting practices, such as the positive accounting theory (Watts and Zimmerman, 1986) and the signaling theory (Ross, 1977). The postulates of these theories have been used to identify determinants of accounting practice and quality of disclosures in number of countries(Ali et al., 2004; Glaum and Street, 2003; Lopes and Rodrigues, 2007). However, these theories could not be used to full extent in an environment such as Republic of Macedonia where there is large ownership concentration in listed companies (being owned by small number of dominant shareholders, often family related) and there is a lack of genuine interest or need among investors for financial statements prepared to full extent in accordance with IFRS requirements. Our main research question is:

What are the determinants of good risk reporting practices in financial statements of Macedonian listed companies?

2. Literature review and hypothesis development

The area of research related to determinants of disclosure practices and accounting policy choices based on company-specific characteristics is very extensively explored in the past two decades by accounting researchers. Most of the studies use self-constructed disclosure indices to quantify the degree of compliance with IFRS or accounting standard(s) requirements and explore factors that influence this degree of compliance. These studies examine annual financial statements of investigated companies that claim compliance with accounting standards. For example, Glaum and Street (2003) investigate the compliance level of companies listed on Germany's New Market with both IAS and U.S. Generally Accepted Accounting Principles (GAAP) disclosure requirements. Their findings reveal that compliance levels range from 41.6% to 100%, with an average of 83.7%. Both univariate comparison and analysis that controls other firm characteristics indicate that the average compliance level is significantly lower for companies that apply IAS than those that apply U.S. GAAP. The average compliance level is significantly lower for companies that apply IAS as compared to companies applying US GAAP. The overall level of compliance with IAS and US GAAP disclosures is positively related to firms being audited by Big 5 auditing firms and to cross-listings on US exchanges.

Significant number of research studies have addressed the issue of compliance with financial reporting requirements and the effect of corporate characteristics on the level of disclosure (Chalmers and Godfrey, 2004; Cooke, 1989; Dumontier and Raffournier, 1998; Glaum and Street, 2003; Hodgdon et al., 2009; Street and Gray, 2002; Tower et al., 1999). The characteristics usually considered include the size, industry, listing status,

leverage or gearing of the company, ownership structure and concentration, profitability, type of auditor and some corporate governance characteristics such as the existence of audit committee. A lot of studies have provided both supportive and non-supportive evidence in favor of these determinants. Also, a great number of studies are comparative in nature and examine the country level determinants that influence the compliance with accounting standard requirements such as legal systems, culture, securities regulation, capital market supervision and existence or inexistence of rigorous enforcement of accounting standards. Street and Gray (2002) reported positive association between the level of compliance with IAS disclosures and having US or International listing status, the type of industry the reporting entity belongs to (commerce or transportation) and being audited by Big Five audit firm at that time.

First, the level of disclosure is expected to increase with the firm size, the reason behind this association is provided by agency theory and political cost theory. Larger firms have higher agency costs than smaller firms, since monitoring is more difficult and costly in larger organizations (Jensen and Meckling, 1976). According to Watts and Zimmerman (1986) political costs are higher for large companies, who tend to disclose more information in order to increase confidence in their affairs. Large companies have superior information systems providing them with additional information at no cost. The proprietary cost theory developed by Verrecchia (1983) and Dye (1985) argues that the management quantifies the costs and benefits of disclosing information and decides not to disclose if the costs exceed the benefits. In respect of Macedonian listed entities we expect larger companies to present better disclosures in accordance with IFRS in their financial statements. Accordingly, this paper hypotheses that:

H_1. *It is expected that larger listed companies will have superior levels of risk disclosures in comparison to smaller listed companies.*

The industry in which the company operates can impact the motivation of the management to disclose more or less in the financial statements. Different empirical studies provide evidence in support or against the relationship between the industry type and level of compliance with IFRS/IAs reporting requirements. Glaum and Street (2003) for firms listed on Germany's new market found that industry has no significant effect on IAS mandatory disclosures. In contrast, Street and Gray (2002) report a positive association between compliance with IAS requirements and being in commerce and transportation industry. Lopes and Rodriges (2007) argue that firms operating in the same industry are interested in providing the same level of disclosures as the competition, in order to avoid adverse connotation of their behavior and negative market repercussion. Furthermore, the pressure created by institutions can be observed as industry related. Therefore, we make the following expression for the second hypothesis:

H_2. *Information disclosure practices are related to the type of industry the company belongs.*

The ownership structure of the company influences the motivation of the management to disclose information and comply with regulatory requirements. According to the principle arguments of the agency theory largely distributed ownership structure (large number of small shareholders) results in greater request for information in order to enable shareholders to perform adequate monitoring of their investments (Jensen and Meckling, 1976). Several research studies provide empirical evidence supporting these claims. The research results verify the positive relationship between the level of information disclosure and the level of distribution of ownership structure, non-familiarity in ownership or the independence of the majority represented at board of directors (Chau and Gray, 2002; Prencipe, 2004). Therefore, we predict for an inverse relationship between the ownership concentration and the quality of disclosed information in financial statements of listed entities.

H_3. *The quality of disclosures is expected to be lower for companies showing greater ownership concentration (owned by small number of shareholders).*

Previous studies on disclosure quality have also explored the relationship between disclosure levels and the capital structure of the firm or the firm leverage. Firms with high leverage are generally expected to disclose more information (Abd-Elsalam and Weetman, 2003; Alsaeed, 2006). Usually the 'agency theory' is used to explain the incentive for managers of high-leverage firms to provide more disclosure (Morris, 1987). Alsaeed (2006) argues that firms which are more in debt are influenced by higher agency costs. Managers have an incentive to reduce these agency costs and therefore they disclose more information to satisfy the needs of debt holders. Similarly, Wallace et al. (1994) argue that high-leverage firms have a greater obligation to satisfy the informational needs of creditors and, thus, may provide more detailed information in their annual reports than low-leverage firms. In examining the association between disclosure levels in annual reports and various firm characteristics, Ahmed and Courtis (1999) find a statistically significant positive association between firm leverage and disclosure level. Consequently, this paper hypothesis that:

H_4. *The level of compliance with risk disclosure requirements is positively associated with firm's leverage.*

Previous disclosure research has determined that profitability influences a firm's disclosure level (Ali et al., 2004; Gallery et al., 2008; Wallace et al., 1994; Wallace and Naser, 1995). Most of these researchers claim that managers will more likely disclose more information when profitability is high in order to project their ability to

maximize shareholder's wealth, justify and secure their engagement. On the other hand, a firm may disclose less information when profitability is low in order to hide losses or reasons for bad profitability results. Agency theory could provide reasoning behind these claims, when managers achieve better performance they disclose more detailed information to the market about the good news than when they perform badly.

The empirical findings of prior research on the association between firm profitability and disclosure level are mixed. For example, Ali et al. (2004) and Gallery et al. (2008) provide evidence of a significant positive association between profitability and disclosure. In contrast Street and Gray (2002) and Glaum and Street (2003) find no significant association between profitability and disclosure. Despite the opposite findings of different researchers, we expected that companies with high profitability will disclose more information to demonstrate ability of managers to increase shareholders wealth.

H_5. *The level of compliance with risk disclosure requirements is positively associated with firm's profitability.*

IFRS disclosure studies regularly investigate the relationship between a firm's disclosure level and the type of external audit firm engaged. A positive relationship between disclosure level and the quality of external audit has been reported in several studies. DeAngelo (1981) argues that larger auditing firms have well-established reputations and, therefore, have more to lose if they fail to report errors or misrepresentations in financial statements of audit clients. Thus, DeAngelo claims that larger auditing firms have a greater incentive to maintain independence from their clients and report non-compliance with rules and regulations. Wallace and Naser (1995) claim that larger auditing firms are less likely to depend on one or a few clients. The apparent lack of bonding with clients enables larger auditing firms to demand greater disclosure in their clients' corporate annual reports. Macedonian audit market has specific characteristic where significant market share is in possession of "Big Four" audit firms, in addition to large market share taken by former local firms who successfully joined international networks of professional accounting firms. Therefore, for this independent variable we have formulated the following hypothesis:

H_6. *The quality of risk disclosures is more appropriate for companies audited by international network audit firm.*

3. Methodology and data

3.1 Sample selection

The initial sample comprised 116 companies listed on the official and mandatory listing segments of Macedonian Stock Exchange as of 31 December 2013. However, the sample was reduced since only 104 companies have made their audited financial statements for 2013 publicly available at the time of the completion of the analysis. Financial statements for prior periods were not considered, since in 2013 changes were introduced on Macedonian Stock Exchange when 85 companies were required to enter the separate market segment of mandatory listed companies and expected to follow transparency rules applicable for other listed entities. This was done in order to boost investors' interest for the shallow capital market.

3.2 Research model

In order to test the determinants of disclosure quality, I've used a model in which the dependent variable is the disclosure index constructed on the basis of relevant requirements of IFRS 7 for disclosure of information on financial risks associated with financial instruments. The constructed disclosure index containing 22 disclosures is a dichotomous, unweighted and adjusted for disclosures which are not applicable for respective companies and their financial statements. Dichotomous means that each disclosure included in the financial statements or in the notes is assigned with the score 1 in the total sum for the index, otherwise the absence of applicable disclosure is scored 0. The total of the index for a certain company is calculated as:

$$T = \sum_{i=1}^{m} d_j$$

where d_j is 1, if the information i is disclosed, otherwise 0; m being the maximum number of disclosures (m=22).

The total score is computed as the unweighted sum of the scores of each item. The implied assumption is that each item is equally important for all user groups. This assumption may not be realistic, but I think that the resulting bias is smaller than the one that would result from assigning subjective weights to the items. The majority of disclosure studies use this approach of unweighted indices (Chalmers and Godfrey, 2004; Cooke, 1989; Raffournier, 1997). The main argument for using this type of indices is related to the insignificance of the weighting, since different users of financial statements will determine different weighting factors for different disclosures dependent on their different needs. The end result, if different requirements of different users are respected, will be netting of different weighting factors and their opposite effects.

The disclosure index specifies the maximum number of individual risk information to be included in financial statements, if the company is involved in transactions with financial instruments with all possible risks. As a condition, this is highly unlikely to be satisfied, therefore each reporting company has unique transactions and

economic events that generate specific portfolio of assets and liabilities. As a result, when valuing disclosures and determining disclosure index of each company, importance should be given to the applicability of disclosures. We have given appropriate consideration to the applicability of disclosures when the index was calculated in order not to decrease the result of the company for items that are not disclosed, and are irrelevant. Therefore, the maximum result for each company is determinable by the formula:

$$M = \sum_{i=1}^{n} d_j$$

where d_j is disclosed information; n is the number of disclosures applicable for the company (n≤22). The procedure for adjustment of the index has been applied in other relevant research papers (Cooke, 1989; Raffournier, 1997). The result for the index at each company as dependent variable is described through the following formula:

$$IndexOb = \frac{actual\ result\ in\ disclosures\ of\ the\ company}{maximum\ result\ of\ applicable\ results\ for\ the\ company}$$

According to the hypotheses given above, determinants of disclosures subject to testing are: the size of the company, the industry in which it belongs, ownership concentration, leverage, the profitability and the type of auditor. The size of the company can be measured according to different criteria. In the model applied, the size of the company (SIZE) as continuous variable is measured according to two criteria: total income (TotInc) and total assets (TotAss) expressed in thousand denars. Usually these criteria for company size are used in other disclosure studies.

The industry to which the company belongs is defined as dummy variable (IND) that can take score 1 if the company belongs to the financial sector or 0 if the company belongs to non-financial sector. In the literature there is no unique way to categorize industries in order to make the best exploration of their effect on the quality of financial reporting. We believe that classification approach considered is best suited for the circumstances and the environment of the financial reporting process in Macedonia. The quality of financial reporting of Macedonian banks in general is superior in comparison to the financial reporting of commercial entities from other industries, as a result of the significant role of the Central bank of Republic of Macedonia as an effective regulator and supervisor of banks' operations.

Concentration of ownership (OWN) as independent continuous variable can inversely influence the degree of disclosures in financial statements. Macedonian capital market is characterized with the presence of small number of listed entities and high ownership concentration, even for listed entities which often act as family owned firms. The corporate governance environment is characterized with inappropriate separation of management and ownership of the company, where dominant shareholders often occupy top executive positions. In such companies, there is an absence of systems that will inform current and potential shareholders timely and correctly.

Another independent continuous variable used in the study to explain the disclosure index of each company, is the leverage of the company (LEV). We have measured this variable through the debt to equity ratio. The profitability (PROFIT) is measured through the ROE (return on equity) measured as ratio of net income for the year to average shareholders' equity. The type of engaged audit firm is considered as dummy variable (AUD), in this case scored 1 if the audit firm belongs to international network or 0 if it is another audit firm.

Based on explanations presented above regarding dependent and independent variables, the research model that describes the actual disclosure index is defined according to the following equitation:

$$IndexOb = \alpha_0 + \alpha_1 SIZE + \alpha_2 IND + + \alpha_3 OWN + \alpha_4 LEV + \alpha_5 PROFIT + \alpha_6 AUD$$

where

IndexOb= is the disclosure index result of the company;

SIZE = log of total assets or log of total income

IND= dummy variable for the industry; 1 for financial companies, 0 for non-financial companies;

OWN= percentage of ownership concentration for shareholders in possession of more than 5% of common shares;

LEV= ratio total debt/ book value of equity;

PROFIT= ratio of net income/ average shareholders' equity

AUD= dummy variable for the audit firm; 1 for International network firm, 0 for other audit firms;

4. Descriptive statistics

The descriptive statistics for continuous variables are listed in table 1. The data is derived from 2013 audited financial statements of listed companies of Macedonian Stock Exchange.

Table 1: Sample descriptive statistics

	N	Maximum	Minimum	Mean	S.D.
Total assets	104	86,832,539	141,476	7,683,922	18,279,814
Total income	104	25,997,931	25,765	1,848,447	4,088,264
Ownership concentration	104	98.40	7.62	67.40	25.39
Leverage	104	13.01	0.00	1.56	2.90
Profit	104	1,990,378	-150,078	150,366	381,538
	N	%			
Industry					
Financial	13	12.50%			
Non-financial	91	87.50%			
Auditor type					
International network	61	58.65%			
Local firm	43	41.35%			

Most of analysed companies belonged to non-financial sector (87.5%) and majority of them were audited by an audit firm which is part of international network (58.65%). Regarding the extent of compliance with risk disclosure requirements on average listed companies were complied with 66.78% of the maximum applicable disclosures. Significantly greater compliance have demonstrated listed companies audited by international network firm (89.98%) in comparison to listed companies audited by a local audit firm (34.74%).

Table 2: Dependent variable means by auditor type, industry and ownership concentration

	Disclosure index	
	Mean	S.D.
	0.6678	0.0401
Auditor type		
International network	0.8998	0.0636
Local firm	0.3474	0.0729
Industry		
Financial	0.9092	0.0412
Non-financial	0.6075	0.2861
Ownership concentration		
Dominant	0.6440	0.2913
Non-dominant	0.7524	0.2472

The highest level of compliance with risk disclosure requirements was demonstrated by financial sector companies (90.92%), with significantly lesser standard deviation in comparison to non-financial sector companies. The statistics on mean ownership concentration (67.4%) shows that on average Macedonian listed companies have highly concentrated ownership among few dominant shareholders. More than three quarters of the companies in the sample had dominant shareholders. The qualitative analysis of the disclosure practices of listed companies have shown that all companies have provided qualitative disclosures explaining financial risks arising from financial instruments, risk management objectives and policies, as well as reasons and sources of risk.

Table 3: Disclosure of nature and extent of risks arising from financial instruments

IFRS		(%)
7.33a	Qualitative info regarding the risks and how these risks arise	100
7.33b	Objectives, policies and processes for managing the risk and the methods used to measure the risk	100
7.34a	summary quantitative data about its exposure to risk as at the reporting date.	57
	Credit risk	
	An entity shall disclose by class of FI	
7.36a	Disclosed amount that best represents maximum exposure to credit risk at the reporting date	76
7.36b	Description of collateral held as security and other credit enhancements	100
7.36c	Information about the credit quality of financial assets that are neither past due nor impaired	40
7.36d	the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated	9
7.37a	an analysis of the age of financial assets that are past due as at the reporting date but not impaired	56
7.37b	an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired	24
	Liquidity risk	
7.39a	An entity shall disclose a maturity analysis for financial liabilities that shows the remaining contractual maturities	84
7.39b	An entity shall disclose a description of how it manages liquidity risk inherent in 39 (a) above	100
	Market risk	
	Sensitivity analysis	
7.40a	a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date	57
7.40b	the methods and assumptions used in preparing the sensitivity analysis	57

However, as shown in table 3, only 57% of analysed entities have provided quantitative data in order to illustrate the exposure to each financial risk at financial reporting date. Approximately the same number of companies provided sensitive analysis regarding the exposure to market risk. Only 40% of the companies in the sample provided appropriate information about the credit quality of financial assets that are neither past due or impaired, and only 56% of the companies provided age analysis of financial assets that are past due at the reporting date but not impaired.

5. Regression Results

Multiple regression analysis was performed to jointly test the formulated hypotheses, where all independent variables were considered in the models. The different measures for size were highly correlated (correlations between independent variables are shown in appendix A), therefore they were included in different models which is consistent to the approach used by Cooke (1989). In each regression model White's heteroscedasticity consistent variance and standard errors were used (White, 1980). Two hypotheses are statistically validated.

The H_3 which states that disclosure is associated with the ownership concentration is supported by the regression results at the 5% significance level. Although significant the coefficient is very small and positive which is not consistent with the findings in the literature namely Glaum *et al* (2013) who provided evidence that increase in ownership concentration decreases the quality of disclosures in financial statements. H_5 which states that the degree of compliance with risk disclosure requirements is dependent on the type of the audit firm engaged (belonging to international network) is also supported by the regression results at 1% significance level. This finding is consistent with Glaum and Street (2003) and Street and Gray (2002) who find positive relationship between compliance with IFRS requirements and the type of audit firm engaged.

The regression results do not show any significant influence of the size of the companies which is consistent with the findings of the work of Street and Gray (2002), Glaum and Street (2003) and Tower et al (1999). The regression analysis provided no evidence of importance of the companies operating in the financial industry being associated with significantly better disclosures in their financial statements which is inconsistent with the findings of Lopes and Rodriques (2007). Profitability or capital structure (leverage) of the companies also does not influence the quality of risk disclosures in companies' financial statements according to the results of the regression analysis.

Table 4: Regression results

Independent variable	Model 1		Model 2		
	Coefficient	(*t*-statistic)	Coefficient	(*t*-statistic)	
Auditor	0.642026	28.66603	0.63798642	25.1994317	*
Industry	0.00961	0.321088	0.01359791	0.45147768	
Leverage	0.004752	1.285842	0.00491457	1.40039047	
Ownerconcent	0.001061	2.359124	0.00101775	2.32828563	**
Profit	1.86E-08	0.731414	1.68E-08	0.8803624	
Totalass	6.93E-11	0.120924			
Totalinc			1.46E-09	1.01417844	
Observations	104		104		
Adj R2	0.96123		0.96153		

Note: * significant at 1%; ** significant at 5%

6. Discussion and Conclusions

The Macedonian financial reporting environment has been aligned to the requirements of IFRS, since these are translated and adopted as published by IASB. Separate national accounting standards have not been developed and are not applicable for any reporting entity that needs to prepare general purpose financial statements. Currently, IFRS as effective from 1 January 2009 and IFRS for SME are applicable for all preparers depending on their size classification. Recent update to full IFRS into the local language has not been made, due to lack of resources available to key stakeholders to be involved in the translation process.

Regardless of the aspects related to the regulatory environment and enforcement of application of IFRS, the central focus of this study was the actual compliance with IFRS requirements by preparers in the area of disclosure of information related to risks arising from financial instruments. In order to achieve this objective, we have constructed a disclosure index that comprises 22 items of risk information related to financial instruments. The components of the index are based on the requirements of IFRS 7 *Financial Instruments: Disclosures.* We have performed qualitative analysis of the contents of financial statements of Macedonian listed entities and concluded that companies were providing sufficient risk information disclosing on average 66.7% of required information.

Our investigation into factors influencing the degree of compliance with IFRS 7 requirements for risk disclosure have provided evidence that the type of audit firm engaged and ownership concentration contribute to better disclosure compliance. However, the size of the companies, their profitability, financing structure and the industry in which they operate does not influence significantly the degree of their compliance with IFRS 7 risk disclosure requirements. This research brings some insights into the characteristics of Macedonian listed companies, namely the quality of financial reporting and transparency practices as well as their corporate governance structure. However, the study has its limitations, mainly related to the construction of the index of disclosure as dependent variable. We were very careful with the scoring process, however, errors could occur when identifying relevant information or deciding how to deal with non-disclosed information that could or could not be applicable for a particular company. Furthermore, annual financial statements are not the only means used by companies to communicate information on risks. Additional research concentrated on disclosure practices in other years (not only 2013 being investigated here) could provide interesting analyses on the evolution of the quality of the financial reporting process related to financial risks. Despite these limitations, we believe that this research revealed interesting relations between the quality of disclosure practices and several characteristics of Macedonian listed companies.

Future research of longitudinal nature could be planned in order to assess the trends in quality of risk disclosure practices by Macedonian listed entities during several consecutive financial reporting periods. It is highly expected that quality of risk disclosures provided in the financial statements of companies will improve in future periods. Comparative disclosure studies that will include preparers in the sample from different countries in the region of Europe or South-East Europe could reveal some country specific characteristics and their relationship with risk disclosure practices of listed companies from different regulatory environments. It will be interesting to conduct comparative research for longer periods and make comparison between the quality of risk reporting practices before, during and after the European Credit and Economic Crisis.

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