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Improving the relevance of risk factor disclosure in corporate annual reports

Santhosh Abraham [a], Philip J. Shrives [b,*]

[a] School of Management and Languages, Heriot Watt University, Edinburgh EH144AS, UK
[b] Newcastle Business School, Faculty of Business and Law, City Campus East, Northumbria University, Newcastle upon Tyne, NE1 8ST, UK

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ABSTRACT

This research develops a model for assessing the quality of risk disclosures and applies the proposed model to four companies in the food production and processing sector. We contribute to the literature by extending prior work on risk disclosure quality using a longitudinal approach to assess the quality of risk reporting. While previous studies have described disclosure practices, this paper adopts a normative approach to disclosure. By suggesting a way of improving risk reporting disclosures, the paper provides guidance for current and future company managers. In line with previous research, this paper identifies certain problems with existing risk disclosures. Results suggest that company managers prefer providing disclosures that are symbolic rather than substantive. We argue that institutional factors and proprietary costs contribute towards and can explain this behaviour. In suggesting a way forward we highlight the role that stakeholders including managers, users, regulators and auditors can play in improving the quality of risk reporting. Flexibility in reporting could be maintained by adopting a properly monitored 'comply or explain' approach.

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1. Introduction, objectives and contribution

A number of studies have examined risk reporting, yet the topic is still very much in its infancy. Although risk reporting is potentially of interest to a wide range of user groups, recent research has indicated that current risk reporting is unhelpful and does not convey real meaning (Campbell & Slack, 2008; Davies, Moxey, & Welch, 2010; Moxey & Berendt, 2008).

There is now an increasing focus on forward-looking information in corporate annual reports, for example, from regulation (Companies Act, 2006), best practice statements such as the International Accounting Standards Board Management Commentary (IASB, 2010) and the Accounting Standards Board's (ASB) reporting statement on the operating and financial review (ASB, 2006), together with pressure from various stakeholder groups wishing to improve transparency in the post credit crisis era (Institute of Chartered Accountants in England and Wales - ICAEW, 2011). Evidence suggests an increase in the amount of narrative information provided by companies over time (ASB, 2007; 2009; Campbell & Slack, 2008). However, despite this increase, there appears to be limited interest among professional users of this information due to concerns about

* Corresponding author.
E-mail address: philip.shrives@northumbria.ac.uk (P.J. Shrives).

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the quality/usefulness of this form of disclosure (Campbell & Slack, 2008). Where disclosure is non–specific, boilerplate, or merely describes a risk management policy (Linsley & Shrives, 2006), its use is limited.[1]

Traditionally, studies often look at the quantity of information disclosed by companies, yet over the years research has served to remind readers that the *quality* of information is more important than the quantity (for example, Beck, Campbell, & Shrives, 2010; Beretta & Bozzolan, 2004; Hasseldine, Salama, & Toms, 2005; Hooks & van Staden, 2011; Marston & Shrives, 1991). Within the risk reporting literature the majority of studies examine the quantity of disclosure, typically measured using words/sentences or some form of disclosure checklist. One strand of research within this literature examines the particular type of risk disclosure or the quality of disclosure, (for example descriptive or quantitative risk disclosure) and these include Woods and Marginson (2004); Beretta and Bozzolan (2004, 2008); Dobler, Lajili, and Zéghal (2011); Lajili and Zéghal (2005); Linsley and Shrives (2006) and the Accounting Standards Board (2007 & 2009). These studies highlight concerns relating to brief, very general and not sufficiently forward-looking risk disclosure practices. All these studies have one thing in common, namely they indicate a lack of progress in risk reporting.

The overall objective of this paper is to discuss how best to improve reporting of principal risk factors by public listed companies. The outcome of this research suggests three questions that preparers need to address in their disclosures. This study employs a longitudinal approach to assess the quality of risk reporting using four companies within the food production and processing industry. This industry has been chosen because readers are likely to be familiar with its activities and also because of a number risk related issues in this sector. These include food safety concerns (Knowles, Moody, & McEachern, 2007), regulatory investigations over anti–competitive practices (Office of Fair Trading, 2011), change in raw material prices, changes in legislation, brand reputation damage and shifts in consumer preferences (Financial Times, 2005, 2007). Beattie, McInnes, and Fearnley (2004) also focus on this sector as part of their detailed study on narrative disclosures.

This study contributes to this literature by extending prior work on risk disclosure quality using a longitudinal approach to assess the quality of risk reporting. While previous studies have described disclosure practices, this paper adopts a normative approach to disclosure. This study extends and develops the research on risk reporting quality in three ways. First, two complementary theoretical frameworks are utilised to explain the current (problematic) state of risk reporting. Second, risk issues are often dynamic, yet previous studies which focus on only one year of reporting, fail to encapsulate movements in risk reporting. Third, our study provides a model (depicted pictorially) based around three questions which managers and others can use for both preparing and assessing the quality of annual report risk reporting. We provide a fresh perspective to assessing the quality of risk disclosure by moving away from the counting of words and sentences.

This paper proceeds as follows. Theoretical perspectives are discussed and linked to themes; data and method used are then described followed by a discussion of the results. Proposals for improving the quality of risk reporting are provided. Theoretical perspectives are discussed in the light of the results, followed by policy implications and suggestions for further research.

2. Analysing theoretical perspectives on risk reporting

A comprehensive theory of discretionary disclosure which clearly identifies the determinants of disclosure does not yet exist.[2] The selection of the theory appears to depend on the area of discretionary disclosure selected for study and even then practice is inconsistent and "unifying ... empirical findings within a theoretical framework remains a challenge" (Cormier, Magnan, & van Velthoven, 2005, p. 6). A multi–theoretic approach is often thought to be appropriate where no one dominant theory is operating. This is very much the case throughout the disclosure literature. For instance, Cormier et al. (2005) suggest using "wider conceptual lenses" (p. 8) to make sense of different findings in environmental disclosure research and this observation is equally applicable to risk reporting. Although agency theory is often applied in voluntary disclosure studies, it is sometimes criticised for its limitations (Band, 1992). For instance, Lubatkin, Lane, Collin and Very (2007) believe it fails to capture real world views and this "engenders an under-socialized view of agents and principals, thereby reducing the model's relevance" (p. 43). Notwithstanding that other theories are occasionally useful, this study privileges institutional theory alongside proprietary costs theory. These two theories are selected for several reasons. First, they provide a way of explaining and understanding the current problematic state of risk reporting. Second, the theories work particularly well both in concert and individually where they can also capture different aspects of risk reporting. Third, the theories can help understand the processes at work which result in limited and general disclosures which bear little or no relation to the risk identification and management processes within organizations. Finally, the mimetic aspect of institutional theory may also be helpful in envisioning a solution to current limitations of risk reporting. Using these selected complementary and intersecting

[1] We do not necessarily argue that boilerplate disclosure is useless and there may be some circumstances where it can serve a purpose (see Spira & Page, 2010 who argue that in the case of internal control boilerplate disclosures the fact of disclosure may be more important than the content). However, in the case of risk disclosures the authors believe that the fluidity of risk situations is such that disclosures require regular reflection.

[2] Research on risk disclosure often refers to different theories. Our research indicates that in excess of ten theories have been used in prior risk disclosure literature (including agency, attribution, contingency, impression management, information costs, information relevance, institutional, legitimacy, modern portfolio, proprietary costs and signalling). Some studies make reference to a large number of theories (for example, Linsley, Shrives, & Crumpton, 2006; Lopes & Rodrigues, 2007; Marshall & Weetman, 2007) but it is not always clear how the specific theories identified relate to the variables discussed. Surprisingly, a large proportion of studies make no explicit reference to theory at all (Collins, Davie, & Weetman, 1993; Dunne et al., 2004; Lajili & Zéghal, 2005).

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