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Mandatory Financial Reporting Processes and Outcomes

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ABSTRACT

In an extension to the mandatory financial reporting literature, we consider compliance and applicability as intermediate stages in the disclosure decision process, and investigate to what extent these measures explain any variance in the quantity of disclosure. We use financial instruments disclosures as our empirical context because of the level of complexity and diversity of the mandatory requirements. We find that neither applicability nor compliance show statistically significant association with disclosure quantity. By contrast we find that a firm's financial instruments management programme is an important determinant of both applicability and quantity. Finally, we demonstrate the economic consequences of applicability, compliance and quantity through their association with audit fees. For companies that use financial instruments management programmes to a greater extent, audit fees are higher. In contrast, the quantity of financial instruments disclosures appears to reduce audit fees.

1. Introduction

The vast literature concerning the important question of 'what incentivizes companies to reveal information' (see reviews by Healy & Palepu, 2001; Verrecchia, 2001; Leuz & Wysocki, 2008; Beyer, Cohen, Lys, & Walther, 2010) is under-theorized in a mandatory setting (Glaum, Schmidt, Street, & Vogel, 2013). Despite claims that managerial discretion is limited when making mandatory disclosure decisions (e.g. Verrecchia, 2001), empirical studies consistently find incomplete compliance (Hassan, Mohd-Saleh, & Rahman, 2008; Lopes & Rodrigues, 2007; Tsalavoutas, 2011), seemingly facilitated by imperfect enforcement (Brown & Tarca, 2005; Daske, Hail, Leuz, & Verdi, 2008) and driven by country-specific factors and voluntary incentives to disclose information (e.g. Glaum et al., 2013; Street & Gray, 2002).

Using financial instruments reporting as a research context, the purpose of this article is to address a gap in the literature that does not differentiate the pre-disclosure process from the reporting outcome. We explore three inter-related dimensions of this problem: applicability; compliance; and the quantity of information revealed. Through an examination of financial instruments reporting amongst the sample of 58 FTSE100 non-financial firms, we pursue three specific research objectives. First, we ask what affects the applicability of, and compliance with, International Financial Reporting Standard 7 *Financial Instruments: Disclosures* (IASB 2005a) (hereafter, IFRS 7). Second, we consider how applicability and compliance, alongside the extent of a company's financial instruments management programme, affect the quantity of financial instruments disclosures. Third, we examine the economic effects of the

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mandatory disclosure process and outcome. After controlling for known determinants, we estimate the effects on audit fees of: (i) a company's financial instruments management programme; (ii) the applicability of IFRS 7 disclosures; (iii) compliance with IFRS 7 disclosures; and (iv) the quantity of information disclosed under IFRS 7 requirements.

In contrast to prior mandatory disclosure work, we start from the basis that accounting standards require a company to explain the results of its investing, operating and financing policies and decisions. Some elements of this process remain unaddressed. This paper seeks to understand the relationship between firm-specific attributes, the process, the reporting outcome and the economic consequences of that outcome. We specify four identificatory stages of the disclosure process as a motivation for our empirical hypotheses, namely: Is the specific requirement applicable? If so, will the company comply? How much information should be disclosed in relation with a requirement? What are the economic consequences of this decision?

We adopt the following approach. First, we propose that the nature and complexity of a firm's financial instruments management programme will be captured by the level of applicability; where applicability is defined as the number of IFRS 7 requirements which the firm is obliged to adhere. Second, compliance levels measured in relation to what is applicable are determined by the incentives to disclose information (e.g. Glaum et al., 2013; Street & Gray, 2002). In turn, the level of applicability and the level of compliance *should* determine the quantity of information. However, despite identical levels of applicability, some companies may have more to disclose because of the nature of their business. Finally, we question whether the value of financial instruments and/or the quantity of financial instruments disclosures have a complementary or substitute effect on audit fees.

We find the following. First, the overall size of the firm and the extent of financial instruments management programmes are statistically positively related to the applicability of IFRS 7. Jointly, the following explain 58% of the variability in applicability: size, value of total non-derivative financial instruments, risk exposure measured as the fair value of derivative financial instruments (hereafter 'derivatives') disclosed, and whether a firm uses derivatives for speculation or hedging. We adopt these four proxies to measure the extent of a firm's financial instruments management programme. Second, and contrary to our expectations, we find that applicability and compliance are not significant determinants of quantity. However, size and holdings of derivatives are significantly positively related to the quantity of disclosure. The four proxies we adopt for financial instruments management programme (listed above) explain about 25% of the variability in quantity. Third, we find that audit fees are statistically and economically positively associated with the value of non-derivative financial instruments with one standard deviation increase in financial instruments leading to 27% increase in audit fees. This is partially consistent with the notion that a premium is required to compensate for the effort. However, audit fees are not associated with derivatives nor whether a firm uses derivatives for speculation or hedging purposes. Finally, we find a negative association between audit fees and the quantity of financial instruments disclosures. This relation is economically important as 1% increase in the quantity of disclosure results in one half of 1% decrease in audit fees. This may appear inconsistent but it suggests that the audit fee premium can be reduced by a managerial decision to reduce information asymmetry. These results are robust to alternative estimation procedures. Overall, these results confirm the important role of managerial choice in the disclosure decision-making process.

Our study contributes to the mandatory disclosure literature in several ways. Firstly, we shift the focus from compliance as the final outcome of the disclosure process (e.g. Glaum et al., 2013; Street & Gray, 2002) to compliance as an additional intermediate stage that might explain various levels of disclosure. Secondly, while the compliance literature uses applicability as an instrument to calculate compliance, we introduce it as an important factor related to levels of disclosure. Thirdly, we propose that the disclosure decision needs to be considered alongside any related policies and decisions, such as financial strategy. Fourthly, our study contributes to the disclosure literature by providing further evidence that the variability in the quantity of disclosed information is *not* associated with the variability in compliance or applicability (Bischof, 2009; Chalmers, 2001; Dunne et al., 2004; Miihkinen, 2012; Roulstone, 1999). Fifthly, the identification of these three distinct factors is a useful addition to the study of mandatory financial reporting (e.g. Al-Akra, Eddie, & Ali, 2010; Birt, Rankin, & Song, 2013; Bischof, 2009; Lopes & Rodrigues, 2007). Sixthly, our measure of compliance is far more detailed than in related studies (Birt et al., 2013; Lopes & Rodrigues, 2007), which results in a finer measurement of compliance, and as such could be useful in other research contexts. The trade-off resultant from this more granular measurement approach is a smaller sample. Finally, to the best of our knowledge, no prior study has empirically tested the association between audit fees and either the value of financial instruments or the quantity of financial instruments disclosures.

The remainder of the paper is organized as follows. Section 2 presents a brief background, a review of the literature and hypothesis development. Section 3 outlines the research design, sample and methods. Section 4 discusses the results. Finally, Section 5 provides a summary and conclusion.

2. Motivation and related literature

The compliance literature fails to address a number of fundamental questions concerning process and outcome. First, there is an over-reliance on disclosure checklists as the outcome measure of compliance and disclosure without due consideration of the interaction between variability in compliance and the levels of applicability and disclosure quantity. Second, there is not enough attention paid to the related managerial choices, policies and strategies that drive movements in assets (liabilities) or gains (losses) which underpin the disclosure. Third, the implications of voluntarism in a mandatory setting are rarely taken into account. We briefly expand on these three issues below.

With respect to the first concern, checklists can be used to measure compliance (e.g. Al-Akra et al., 2010; Lopes & Rodrigues, 2007; Tsalavoutas, 2011). A recent study by Glaum et al. (2013) finds substantial non-compliance with IFRS 3 and IAS 36 across 17 European countries. These findings may be explained by unintentional neglect (when management overlook particular requirements) or misinterpretation of disclosure rules (e.g. managers conclude that certain requirements do not apply). Intentional neglect is more

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