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Discussion

Mandatory Financial Reporting Processes and Outcomes *A Discussion*

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1. Motivation

The International Financial Reporting Standard 7 (IFRS 7), *Financial Instruments: Disclosures* is one of the most complex required financial disclosure rules issued so far by the IFRS. Further, its application and reporting are essential for the users of corporate financial reports in evaluating corporate risk and valuation. Corporations' use of financial instruments reflects some of the financial decisions in various forms and reasons of the company's management. In particular, for example, financial companies may engage in using financial instruments to mitigate their risk exposure so as to mitigate assets–liabilities mismatch, or in order to reduce their interest rate risk exposure. However, industrial and commercial companies, particularly multinational companies, may also be heavily involved in using such financial derivatives for various reasons. For example, Cisco Systems, Inc., in its MD&A of the *2016Annual Report*, elaborates on its needs to use such financial derivatives to hedge against some of its activities, as it clearly states: "We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows" (p. 26). Cisco goes further and makes it more explicit: "Our attempts to hedge against these risks may result in an adverse impact on our net income." (p. 27). In fact, Cisco discloses that information on its 2016 fiscal year-end, it held $385 million of derivative assets and $54 million in liabilities. Cisco further elaborates on the balances, gains, and losses of its hedging activities in combating its risk exposure from foreign currency and interest rates. Thus, it is hard for one to overlook such a heavy corporate involvement in this sort of transactions and, of course, the investors' demand for the disclosure of these types of activities. That is precisely the purpose of IFRS 7 (IASB, 2005), which mandates elaborate disclosures of such corporate activities as demanded by financial report users. Therefore, academic research on the usefulness on IFRS 7, such as the paper of Bamber and McMeeking (2018), is absolutely essential, relevant, and important.

2. Objectives and hypotheses

Bamber and McMeeking (2018) examine some aspects of IFRS 7 actual disclosures. They specify the paper's objective as "...to provide a broader perspective on the disclosure outcome and the forces that shape it in a mandatory setting, *beyond* compliance and the voluntary incentives to disclose." (pp. 2–3, emphasis added). In particular, the authors focus on three measures of mandatory disclosure process and outcome: (a) applicability, (b) compliance, and (c) quantity of information. For that purpose, they develop the following 11 hypotheses:

H1. The overall applicability level of requirements of IFRS 7 increases in line with a company's financial instruments management program.

H2. Higher level of compliance with IFRS 7 requirements is positively associated with the net benefits of voluntarily disclosing information.

H3. The quantity of disclosure is likely to increase in line with levels of applicability and compliance.

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H4. The quantity of disclosure increases in line with the nature and complexity of a company's financial instruments management program.

H5. Companies for whom the net benefits of disclosure are high are likely to provide more disclosure regardless of applicability levels (low versus high).

H6a. The applicability level of risk-related information is likely to be higher than the applicability level of balance sheet and income statement–related information.

H6b. The applicability level of principles-based requirements is likely to be higher than the applicability level of hard-rules and soft-rules requirements.

H6c. The applicability level of IFRS 7 requirements present in its predecessors IAS 30, 32, and 39 and IFRS 4 are likely to be higher than the applicability level of new requirements introduced in IFRS 7.

H7a. There is no expected difference in the compliance levels between balance sheet, income statement, and risk-related information.

H7b. Compliance with principles-based requirements is likely to be higher than compliance with hard-rules and soft-rules requirements.

H7c. Compliance with inherited requirements in IFRS 7 is likely to be higher than the compliance with those introduced by IFRS 7.

3. Model and reported results

Testing these hypotheses on a sample of 58 London Stock Exchange (LSE) companies that disclosed the IFRS 7 requirements for the first year and for the first mandated year (e.g., fiscal year 2005), Bamber and McMeeking (2018) report the results summarized as follows:

1. Both firm size and the value of derivative of financial instruments are statistically positively related to the applicability of IFRS 7.
2. The *value of financial instruments is not a statistically significant determinant*. However, size, derivatives, and financial instruments explain 56% of the variability in applicability.
3. The study is unable to confirm that compliance is affected by any of its potential determinants.
4. "*Applicability and compliance are not significant determinants of quantity*. However, size and derivatives are significantly positively related to the quantity of disclosure. Jointly with the value of financial instruments overall, they explain about 24% of the variability in quantity (without additional controls used)" (p. 5).
5. *Applicability has a second-order effect on quantity,* as the net benefits of voluntarily disclosing information play a much larger part in explaining the variability of quantity when the applicability levels are low than when they are high.

Bamber and McMeeking (2018) conclude that their empirical results are in line with the role of firms' financial policy and their risk management decisions.

These results are based, primarily, on the following sequential regression models:

$$APPL_i = \alpha_i + \sum_{j=1}^{3} \beta_j FINMANPROG_i + \sum_{j=1}^{3} \gamma_j NBENDISCL_i + \sum_{k} \delta_k CONTROLS_i + \epsilon_i \tag{1}$$

$$COMPL_i = \alpha_i + \lambda_1\, APPL_i \sum_{j=1}^{3} \beta_j\, FINMANPROG_i + \sum_{j=1}^{3} \gamma_j\, NBENDISCL_i + \sum_{k} \delta_k CONTROLS_i + \epsilon_i \tag{2}$$

$$QUAN_i = \alpha_i + \lambda_1\, APPL_i + \lambda_2\, COMPL_i + \sum_{j=1}^{3} \beta_j\, FINMANPROG_i + \sum_{j=1}^{3} \gamma_j\, NBENDISCL_i + \sum_{k} \delta_k CONTROLS_i + \epsilon_i, \tag{3}$$

where *APPL* is the number of applicable IFRS 7 requirements/Total IFRS 7 requirements (133), *COMPL* is the number of IFRS 7 requirements appropriately met/Number of applicable IFRS 7 requirements, *QUAN* is the natural logarithm of the number of words related to financial instruments, *FIMANPROG* is a list of variables representing the financial instruments management program, and *NBENDISCL* is a list of variables representing the net benefits of voluntarily disclosing. Controls include financial instruments relative size (*FI*), firm size, estimated risk (*RISKEXP*), such as (Derivative assets + Derivative liabilities)/Total assets, the number of analysts following the firm (*AF*), financial leverage (*LEV*), and current ratio (*CR*).

The idea behind using these sequential regression models is to test the *incremental* effect of the determinants of the dependent variables (i.e., *COMPL*, *QUAN*).

4. Suggestions

Bamber and McMeeking's (2018) study may perhaps benefit from some potential improvements and extensions of their testing procedure. The following are some comments and suggestions on possible modifications to the economics of the testing models and

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