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What drives mandatory and voluntary risk reporting variations across Germany, UK and US?[☆]

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A B S T R A C T

This paper utilises computerised textual analysis to explore the extent to which both firm and country characteristics influence mandatory and voluntary risk reporting (MRR and VRR) variations both *within* and *between* non-financial firms across Germany, the UK and the US, over the period from 2005 to 2010. We find significant variations in MRR and VRR between firms across the three countries. Further, we find, on average, that German firms tend to disclose significantly higher (lower) levels of risk information mandatorily than UK (US) firms. German firms, on average, tend to reveal considerably higher (lower) levels of VRR than US (UK) firms. Our results document that MRR and VRR variations are significantly influenced by systematic risk, the legal system and cultural values. We also find that country and firm characteristics have higher explanatory power over the observed variations in MRR than over those in VRR.

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1. Introduction

This paper investigates the extent to which firm and country characteristics explain variations in mandatory risk reporting (MRR) and voluntary risk reporting (VRR), both *within* and *between* non-financial firms across Germany, the UK and the US during the period from 2005 to 2010. Seeking factors (firm and country characteristics) that interpret variations in MRR and VRR across the three countries answers the calls of Linsley and Shrives (2006) and Dobler, Lajili, and Zeghal (2011) regarding extant gaps in the current body of literature on risk reporting. Each of these countries exhibits a distinctive approach to risk reporting. The first approach (Germany's) is underpinned by a significant emphasis on MRR. The second (the UK's) emphasises voluntary rather than mandatory risk reporting. The third approach (that of the US) represents a compromise between the UK and German approaches.

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Consistent with Jorgensen and Kirschenheiter (2003, 2012), MRR expresses the risk information that firms exhibit within or above, but still related to, risk regulations that set the minimum requirements. VRR expresses any other information about risk included in the narrative sections of annual reports. We measure MRR and VRR with a computer-based approach using QSR version 6, searching the text and counting the number of statements that indicate risk.[1] Automated risk reporting scores are validated manually and statistically to ensure their reliability. Firm characteristics are captured by firm risk levels and some control variables. First, based on the literature examining the association between market and accounting risk measures (e.g., Beaver, Kettler, & Scholes, 1970; Ecker, Francis, Olsson, & Schipper, 2009), we include both market risk measures (market returns volatility, beta and volatility of the standard error of the capital asset pricing model (CAPM) as measures of total, systematic and unsystematic risk, respectively) and accounting risk measures (leverage and current ratio as measures of financing and liquidity risks, respectively). Based on the literature looking at variations in disclosure practices (e.g., Hope, 2003; Jaggi & Low, 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), we utilise legal systems and cultural values to capture the country characteristics.

For both the level 1 (*within* firms) and level 2 (*between* firms) analyses, we apply repeated measures multilevel analysis (Dong & Stettler, 2011; Hox, 2010) in order to capture variations in MRR and VRR and then associate those variations to firms' risk levels. This analysis combines cross-sectional with time-series data, and accounts for residual dependency (Gow, Ormazabal, & Taylor, 2010).

Although considerable attention has been paid to risk reporting recently, the majority of the research focuses on a single country (e.g., Li, 2008; Linsley & Shrives, 2006), or is heavily restricted to one category of risk reporting (e.g., foreign exchange rate disclosure (Marshall & Weetman, 2002, 2007), MRR (Li, 2008) or aggregated risk reporting (Linsley & Shrives, 2006)). None of this research takes as its principal aim the examination of how and to what extent underlying risk levels influence the different levels of risk reporting firms exhibit in their annual report narratives, nor does any of it investigate how country-level characteristics influence the nature and extent of MRR and VRR.

In a recent and highly relevant piece of multi-country research, based on 40 manufacturing firms from Canada, Germany, the UK and the US in 2005, Dobler et al. (2011) investigate the key characteristics of firms providing aggregated risk disclosure, and their association with the regulations in the countries. They do not distinguish, however, between MRR and VRR, although Germany and the US are more highly regulated than the UK with respect to risk reporting. This suggests that MRR will dominate VRR in both Germany and the US to a much greater extent than in the UK. Their results do not support the underpinning argument that firms should respond sensibly to their underlying risks by revealing risk information.

A firm's choices on whether to engage in disclosure activities are not always directly related or restricted to the economic incentives generated by market forces (e.g., Aguilera & Cuervo-Cazurra, 2004; Chen & Roberts, 2010; Judge, Li, & Pinsker, 2010). Neo-institutional theory comprises both institutional and market pressures, and explains why firms might vary in their response to regulations or even to the best practices among their competitors (e.g., Aguilera & Jackson, 2003). Based on this theory, the rational logic behind exhibiting risk information mandatorily and/or voluntarily stems from different levels of pressure generated from regulations and/or best practices, encouraging firms to respond so as to meet social norms and be acceptable (e.g., Chen and Report, 2010).

Our results, based on 3685 firm-year observations, show significant variations in both MRR and VRR *within* and *between* firms over 2005 to 2010, across the three countries. We find the variations in MRR and VRR to be significantly associated with systematic risk, the legal system and cultural values. We also find that the latter two are significantly more essential in explaining variations in MRR than VRR.

This paper makes several contributions to research on risk reporting. First, we observe changes over time in both MRR and VRR, and then associate such changes with variations in risk levels captured through a comprehensive set of market and accounting risk measures. Second, to the best of our knowledge, we are investigating these associations on the largest set of data used within risk reporting research to date. When we further associate the observed trend in firms' MRR and VRR with the underlying risks in each country, we find signals that either support or warn the German, UK and US regulators regarding their approaches to risk reporting. Given that each approach supports a particular type of risk reporting, the extent to which the underlying risks motivate managers to respond sensibly by reporting risk information either mandatorily or voluntarily becomes the main criterion for assessing the approaches. Finally, based on simultaneous interactions between, and the influence of, firm and country characteristics, this paper provides the first empirical evidence of how corporate risk reporting varies within and between firms under the three distinct approaches to risk reporting taken in Germany, the UK and the US. The observed pattern of VRR variations within and between firms across these countries differs from the variations in MRR. This conclusion has theoretical and practical implications:

Theoretically, either general disclosure research or risk reporting research might usefully distinguish between the trends in mandatory and voluntary risk reporting, avoiding the misinterpretations due to relying on the aggregated disclosure score, so as to draw conclusions about either VRR or MRR. In practical terms, the higher ability of legal and cultural values to explain

[1] QSR is a qualitative research software developed for analysing textual data. It has introduced many pieces of software such as NUD*IST in its various versions (1–6), which it was later upgraded to NVivo. Our paper relies on QSR NUD*IST version 6, henceforth QSR version 6. NUD*IST stands for Non-numerical Unstructured Data Indexing, Searching and Theorizing. One of the key advantages of using QSR version 6 over NVivo is the flexibility of choosing the unit of coding, as desired, to be either a sentence, a line or a paragraph. Our paper uses the sentence as the unit of analysis to avoid the double-counting problem (Kravet & Muslu, 2013), which is a weakness inherent in other dictionary-based software programs (e.g., General Inquiry). For a recent review see Li (2010).

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