Journal of International Accounting, Auditing and Taxation 29 (2017) 81–102

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation

journal homepage: www.elsevier.com/locate/intaat

Full length article

Risk disclosures, international orientation, and share price informativeness: Evidence from China

Youchao Tan[a], Cheng Colin Zeng[b,*], Tamer Elshandidy[c]

[a] School of Accounting, Southwestern University of Finance and Economics, Chengdu, China
[b] Alliance Manchester Business School, University of Manchester, Manchester, United Kingdom
[c] University of Bradford School of Management, University of Bradford, Bradford, United Kingdom

ARTICLE INFO

JEL classification:
D8
G24
G12
M4

Keywords:
Risk disclosure
Stock price synchronicity
International orientation

ABSTRACT

This paper examines the impact of textual risk disclosure on the amount of firm-specific information incorporated into share prices, as measured by stock price synchronicity. Using a sample of Chinese listed firms, we find that synchronicity is inversely associated with the extent of risk disclosure, suggesting that risk disclosure is firm specific and useful to investors. In addition, our results show that the usefulness of risk information is statistically and economically more pronounced among internationally oriented firms than domestically oriented ones. This result is consistent with the necessity for risk disclosure being more meaningful when it relates to greater uncertainty. Finally, we find that internationally oriented firms tend to disclose more risk factors than their domestically oriented counterparts. Overall, our results shed light on the current debate over whether narrative sections of annual reports convey useful information to investors.

1. Introduction

Considerable attention has been paid recently to risk-related disclosure. Such attention is even greater during difficult times such as corporate scandals (e.g., Enron, WorldCom, American Insurance Group, and Lehman Brothers) and economic crises (e.g., 2007–2008′s subprime mortgage crisis). In such circumstances, the question of whether accounting is functioning effectively by providing the public with relevant information becomes increasingly crucial and, as a result, more pressure is put on professional bodies by the regulators (e.g., Barth and Landsman, 2010). For instance, in the US in 1997, the Securities and Exchange Commission (SEC) published Financial Reporting Release (FRR) No. 48 on the market risk of financial instruments, mandating the presentation of both qualitative and quantitative market risk information.[1] Similarly, Sections 302 and 404 of the Sarbanes-Oxley (SOX) Act obligate firms to provide information about their significant risks, derivatives and hedging activities. Since the release of these two documents, the literature on risk disclosure has been dominated by empirical examinations of the extent to which US firms convey useful risk information based on the contents of FRR (48) (e.g., Campbell, Chen, Dhaliwal, Lu, & Steele, 2014; Hodder and McAnally, 2001; Jorion, 2002; Kravet and Muslu, 2013; Linsmeier, Thornton, Venkatachalam, & Welker, 2002; Rajgopal, 1999).

Unlike the US mandatory approach towards risk disclosure, the China Securities Regulatory Commission (CSRC) encourages Chinese listed companies to discuss risk factors in their annual reports, "following the principle of importance and disclosing major risks that may have an adverse impact on the realization of the firm's development strategies and business objectives in the next year"

* Corresponding author at: 1 1 Crawford House, Booth Street East, Manchester, M13 9SS, United Kingdom.
E-mail addresses: tanyouchao@swufe.edu.cn (Y. Tan), cheng.zeng@mbs.ac.uk (C.C. Zeng), T.Elshandidy@bradford.ac.uk (T. Elshandidy).

[1] FRR (48) deals with the market risk of derivatives, and provides three formats for quantitative disclosure: sensitivity analysis, value at risk and tabular formats. These three formats should provide the impacts of any changes in the market rate and prices on cash flow, earnings and fair value.

http://dx.doi.org/10.1016/j.intaccaudtax.2017.08.002

Available online 08 September 2017

(CSRC (2005) No. 141). However, this framework only provides guidelines on risk reporting and final decisions over the form and contents of their disclosure are left to the firms.

Arguably, two competing motives underpin managers' decisions to either withhold or reveal meaningful information (Beyer, Cohen, Lys, & Walther, 2010). Specifically, the voluntary nature of the CSRC's requirements allows management of Chinese firms discretion over what risk information to disclose. Firm managers might have disincentives to disclose risk as doing so might draw the market's attention to the firm's riskiness (e.g., Elshandidiy et al., 2013) or increase investors' perceptions of risk, causing them to increase their risk premium to compensate for high risk exposure (e.g., Kravet and Muslu, 2013; Campbell et al., 2014). To avoid potential deterioration in market value, managers of such firms might withhold risk information or minimize its usefulness. Furthermore, given that the Chinese market has relatively low information transparency and poor investor protection (e.g., La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), investors have reasons to doubt the reliability and usefulness of the risk factors disclosed by Chinese listed firms.

On the contrary, investors need useful risk information as it provides direct information on a firm's risk profile, which may in turn affect investors' assessments of expected cash flows (Miihkinen, 2013). Providing risk information might reduce investors' uncertainty related to future cash flows, which reduces their risk premiums (e.g., Elshandidy and Neri, 2015; Jorgensen and Kirschenheiter, 2003). Decreased risk premiums lead to a lower required rate of return, which is widely used in practice as a discount factor for investors' future cash flows. Thus, firm managers might have incentives to disclose more meaningful information to their investors.

To better understand the information content of China's corporate reporting, especially narrative reporting, the Association of Chartered Certified Accountants (ACCA) and the Shanghai Stock Exchange jointly conducted a survey in 2010. The results suggest that 82% of the respondents considered disclosed risk factors to be important in decision making (ACCA, 2011). However, the empirical evidence on whether risk disclosure is informative in China remains quite unclear. Thus far, there is little research investigating explicitly whether Chinese firms provide proper risk disclosure, to an extent where investors can rely on it to better understand the firms' risks and uncertainties. Exploring whether risk disclosure is credible within one of the largest and fastest-growing economies in the world is becoming increasingly vital. This is especially true because the Chinese context is quite unique (e.g., the approach towards risk disclosure relies on encouraging rather than requiring firms to reveal risk information and investor protection is generally weak), differing from other contexts where the usefulness of risk disclosure has been tested (e.g., Campbell et al., 2014; Kravet and Muslu, 2013). Making generalizations, therefore, based on extant evidence on the usefulness of risk disclosure might go against a strong strand of literature that argues that accounting practices (measurements and disclosures) within a specific context (such as China) should reflect its underlying environmental factors (e.g., Dobler, Lajili, & Zéghal, 2011; Nobes, 1998).

Using a unique dataset that measures the extent of risk disclosure of Chinese listed firms during the period 2007–2011, this paper examines the effect of risk disclosure on the amount of firm-specific information incorporated into share prices, as measured by stock price synchronicity. Moreover, we investigate whether the association varies between firms with different levels of risk. Prior research demonstrates that firms possessing greater risk tend to disclose more risk (e.g., Campbell et al., 2014; Dobler et al., 2011; Elshandidy, Fraser, & Hussainey, 2013; Elshandidy, Fraser, & Hussainey, 2015). Stock market regulators around the world also encourage firms to disclose more meaningful risk factors to respond to market-wide fluctuations (Jorgensen and Kirschenheiter, 2003). Our paper pays special attention to the risk information disclosed by Chinese firms that are broadly classified as being internationally oriented on the basis of their foreign sales, for the following reasons. First, internationalization is inherently risky due to increased exposure to various risk factors (e.g., currency and political risks), which in turn increases information asymmetry between management and information users such as analysts and investors (Duru and Reeb, 2002). Second, China did not become a member of the World Trade Organization (WTO) until December 2001. Through rapid development, China surpassed the U.S to become the world's largest trading nation in 2012 as measured by the sum of exports and imports of goods.[2] Consequently, it is imperative for policy makers, firms and investors to consider the risk-reporting practice in such an export-oriented economy.

Our results show that risk disclosure is inversely associated with stock price synchronicity, suggesting that such disclosure is not boilerplate but instead conveys useful information to investors.[3] We also find that the negative association between risk disclosure and stock price synchronicity is more pronounced among internationally oriented firms (IOFs) than domestically oriented firms (DOFs), consistent with risk disclosure being more meaningful when it relates to greater uncertainty. These results explain why, as confirmed by additional analysis, IOFs have greater incentives to disclose more risk factors in their narrative sections than do DOFs. Overall, our evidence supports the argument that firms' exposure to risk affects their choice of risk disclosure contents because investors demand more risk information from riskier firms. Our findings are robust to a variety of sensitivity tests and alternative proxies for risk disclosure, stock price synchronicity and international orientation.

Our study contributes to the extant literature in several ways. First, risk disclosure has been studied regularly in the context of western economies such as the US (Campbell et al., 2014; Kravet and Muslu, 2013). However, it remains unclear whether risk disclosure is informative in emerging economies such as China, despite that country's increasingly important world economic position. To our knowledge, our study is the first to provide direct evidence on the informativeness of risk disclosure in China. Our results help regulatory bodies and investors generally, and corporate disclosure users in particular, to better understand the extent to which, and in what manner, risk disclosure influences firm-specific information capitalization in an environment where overall

[2] See the link: http://www.bloomberg.com/news/articles/2013-02-09/china-passes-u-s-to-become-the-world-s-biggest-trading-nation.

[3] Boilerplate is taken to mean that firms might engage in some forms of risk disclosure where they either will not be useful or less useful to investors. Firms might engage in such forms just to comply with regulations that might require filling some forms such as form 10-K.