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Analysis of Financial Risks Disclosure: Focused on Romanian Capital Market

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Abstract. This study undertakes both qualitative and quantitative analysis. The qualitative analysis focuses on debating developments in the area of risk reporting as well as perspectives for its improvement in relation to the extent of recent expectations calling for changes. This is mainly done by means of literature review. The quantitative analysis investigates the case of an emerging economy by considering risk reporting practices of companies listed on the Romanian capital market. A disclosure index is computed and furthermore used within a regression analysis trying to identify determinants of risk reporting practices. The obtained results document a low level of risk related information being presented by companies listed on the Romanian capital market. Still, corporate governance elements can be used in explaining companies' current risk reporting practices.

Keywords: Corporate Governance, Capital Markets, Disclosure of Financial Risks.

1. Introduction

As emphasized by Walker (2010), recent events have revealed enormous gaps in our understanding of how financial markets and financial governance systems work. A perfectly justified question would therefore be related to where did risk management and corresponding control systems go wrong? We therefore position our analysis at the interference of corporate governance and financial reporting arguing for informational transparency and risk disclosure. The latter's importance should be considered by mainly making reference to the cost of capital and risk management. Furthermore, we draw on results in previous studies documenting the limitations of risk disclosure, as well as the necessity for further developments (Jorion, 2002; Linsmeier et al., 2002; Campbell et al., 2011; Kravet and Muslu, 2011; Lajili and Zéghal, 2005; Kajüter, 2004; Dobler, 2005; Berger and Gleissner, 2006; Beretta and Bozzolan, 2004; Solomon et al., 2000; Linsley and Shrives, 2006; Marshall and Weetman, 2008) as an argument for the discussion being brought forward through our analysis. Pope (2010) arguing that the time is right for theoretical and empirical academic research to revisit the ability of accounting information to reveal risk also emphasizes the opportunity of the proposed analysis.

When looking at research and trade literature in the area of risk management we notice preoccupations intensifying in time. Furthermore, approaches to risk management shifted from debating minimum requirements and standard indicators towards the development of a holistic approach which developed over the last three decades and intensifying over the last one. If we are to separate and synthesize the contribution of previous studies in risk management literature by considering theoretical and empirical studies, we might say that the first debate risk management's ability to create value for the company, while the latter mainly document determinants of risk management and the use of derivatives. What we find as encouraging is noticing the coherence between the results of empirical studies and the theoretical grounding of using derivatives in order to hedge risk. Corporate governance's role in shaping sound policies for derivatives usage is also analyzed (Chang, 1997; Tufano, 1998; Whidbee and Wohar, 1999; Rogers, 2002; Marsden and Prevost, 2005).

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2. Research Methodology

The first component of the employed research methodology involves grounding and computing a disclosure index that captures risk reporting practices of the analyzed companies (as a reflection of also its risk management practices). Secondly our methodology focuses on identifying determinants of these practices as being reflected through the proposed disclosure index. Potential determinants included in the analysis were selected based on similar studies in literature. We will further detail the employed research methodology with regard to both above mentioned dimensions, as well as to the sample companies. In a nutshell we need to explain the grounding of the sample of entities being considered for analysis, their main characteristic elements and governance related elements. Information was hand collected from companies' financial statements as well as other reporting documents that were publicly available for the 2011 financial reporting period.

Selecting the companies that were included in our analysis sample was done in two stages. The first stage involved the consideration of all companies listed on the Bucharest Stock Exchange and developing a preliminary analysis. This led to analyzing a number of 103 sets of financial statements for the 2011 financial reporting period. Based on the developed analysis we further eliminated from the sample those companies that did not publicly present reporting documents and those that were suspended from listing. Furthermore in order to ensure comparability of the analyzed data and by considering the number of consolidated and individual financial statements respectively, we decide to focus our analysis on individual financial statements only. We finally ended up establishing a sample of 76 individual financial statements that were considered in developing the proposed analysis.

We use in the development of our study the following elements, organized into different groups:

A. General corporate governance information

- *GovAct* – separate description of main corporate governance practices;
- *GovMembers* – presentation of a list with the members defining the company's corporate governance system and structures;
- *AGMInfo* – information regarding General Assemblies taking place within the company;

B. Corporate governance specific indicators

- *ManagementStyle* – information regarding the management system (unitary/dual);
- *BoardNo* – number of members within the administrative board;
- *BoardIndep* – number of independent and non-executive board members;
- *GovComm* – the existence of audit committees, nominalization committee that are part of the company's corporate governance as well as their structure;

In order to analyze the relationship between companies' risk reporting practices (as a reflection of risk management practices) and the elements considered as characterizing their corporate governance system we have appealed to constructing and using the following regression model:

$$DI = \alpha + \beta_1 GovAct + \beta_2 GovMembers + \beta_3 AGMInfo + \beta_4 ManagementStyle + \beta_5 BoardNo + \beta_6 BoardIndep + \beta_7 GovComm + \varepsilon_i$$

All the variables being comprised in this model have been previously explained. The following section of the chapter develops the proposed analysis and presents the obtained results.

3. Results

Developing the analysis involved the implementation of the ordinal regression model in order to analyze the probability and magnitude of the connection between risk reporting practices (as a reflection of risk management practices) and corporate governance elements that were considered for the sample companies. In order to document that the proposed model is fitting we have applied two supplementary tests, namely the likelihood ratio test and chi-square goodness of fit. We report the Cox-Snell R^2 prediction accuracy (R^2) and Nagelkerke measure to indicate the power of the ordinal model.

Table 1: Ordinal Regression Analysis

	Coefficient Estimate	Wald χ^2	p-value
Independent Variables			
GovAct (+)	1.107	9.692	0.000
GovMembers (+)	0.510	4.510	0.019
AGMInfo (+)	0.211	2.338	0.023
ManagementStyle (+)	0.744	1.980	0.028
BoardNo (+)	0.589	2.320	0.071
BoardIndep (+)	0.896	1.889	0.024
GovComm (+)	0.523	2.597	0.068
Model χ^2 = 57.223, p < 0.000.			
Pearson Chi-Square = 107.11, p-value = 0.922			
Deviance Chi-Square = 111.34, p-value = 0.871			
Pseudo R-Square			
Cox-Snell	0.395		
Nagelkerke	0.337		
All of the independent variables are defined above.			

Source: authors' analysis

As seen from the above presented results, our sample companies document the existence of a relationship between the considered corporate governance elements and their risk reporting practices (as a reflection of risk management practices). When considering all the variables included in the analysis and the value for Model χ^2 = 57.223, while p-value < 0.000, we may conclude that we have a well-fitting model. This is proved also by the registered results related to the goodness-of-fit tests and the values for Pseudo R-Square (Cox-Snell 0.395 and Nagelkerke 0.337).

4. Conclusion

The results of the analysis being developed on listed companies of an emerging economy document a low level of risk related information being presented by companies. We conclude after having analyzed a number of 76 sets of financial statements that companies rather aim for conformity with requirements than for reporting information that would be consistent with user needs. An example in this regard is even the manner in which companies discuss performance in publicly available reports. We consider such results to be useful in the sense that it should further allow developments in order to improve companies' risk reporting practices and also risk management. The limitations of our study include a low number of sample companies and the impact of the elements being considered when constructing the disclosure index.

It is obvious that risks are difficult to be quantified in an objective manner. This imposes consequences in terms of risk reporting that, despite covering both qualitative and quantitative data, remains subjective and limited as a scope. Whatever risk quantification we might think of, supposable based on objective computations, is in fact subjective:

Risk is inherently subjective… [R]isk does not exist 'out there', independent of our minds and cultures, waiting to be measured. Instead, human beings have invented the concept risk to help them understand and cope with the dangers and uncertainties of life. Although these dangers are real, there is no such thing as real risk or objective risk. Even the simplest, most straightforward risk assessments are based on theoretical models, whose structure is subjective and assumption-laden and whose inputs are dependent upon judgment. (Paul Slovic quoted in Victor Ricciardi, A Risk Perception Primer: A Narrative Research Review of the Risk Perception Literature in Behavioral Accounting and Behavioral Finance, quoted by ICAEW, 2011).

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