An Empirical Analysis on the Practice and Determinants of Voluntary Risk Disclosures by the Non-Financial Listed Companies in Japan

著者

学位授与機関

学位授与番号

タイトル
Abstract of Thesis

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Submission Date:
30th June, 2017
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Abstract

Risk is an inherent element of a business. Business organizations take various types of risks for maximization of shareholders’ wealth. But an organization may suffer in achieving its targeted goals and objectives and may damage shareholders’ value if they cannot manage the risks in proper way. So, it is the responsibility of the management as the agents of the shareholders to inform principals about all the possible risk factors that have already or will impact on the business performance and financial position of the companies.

A series of high-profile corporate failures (Enron, WorldCom) and incidents that have damaged well-known brands had already increased the interest in risk reporting in the early 2000s. In addition, financial crisis of 2007–08 also focused on the issue that accounting information is not sufficient enough to identify the risks related to business. Business organizations take various types of risks for maximization of shareholder’s wealth. Shareholders need to be well informed about the impact of those risks on business performance and techniques management has utilized to manage and mitigate the impacts of those risks.

Risk reporting is not new in Japan. Konishi and Ali (2007) mention that the level of risk reporting has increased in 2004, at least in quantity, in annual reports after the issuance of regulatory guidelines on risk reporting by the ASBJ in Japan. However, this guideline does not provide any clear direction about what kind of risk information should be disclosed, how to measure risk or how to measure the effects of risk to business. It considers risk discloser as an internal affair of the concerned companies and has left it to them as to when and how to report risk information.

This study focuses on the measurement of volume of risk factors disclosed voluntarily by the Japanese companies, their nature and decision usefulness to the users in terms of measuring the quality of risk disclosure. In addition, this study identifies firm specific and corporate governance specific characteristics that drive quantity and quality of risk factors disclosed by the companies. This research will investigate the risk disclosure practice by the Japanese companies (companies included in JPX-Nikkei 400 index) over the periods 2009-10 to 2014-15.

The objectives of this research are i) to identify the different categories of risks disclosed voluntarily within the annual reports by the companies over six years (FY 2009 to FY 2014) based on a risk disclosure index; ii) to identify the risk factors prioritized under different categories by the companies; iii) to identify deviation in risk disclosure practice in terms of quantity and quality over the years and industries; iv) to investigate the determinants of the risk disclosure levels based on firm specific and corporate governance specific characteristics; v) to develop a framework for measuring quality of risk
To find out the impacts of firm and corporate governance specific characteristics on quality risk information disclosure and to find out the motivational and de-motivational factors for management to disclose risk information in the light of disclosure theories. This research will find out a comprehensive picture of the voluntary risk disclosure practice by the Japanese companies regarding both the volume and the quality of risk information revealed.

Including Statement of Business risks in annual reports may be a significant evolutionary step in responding both to investor demands for forward looking information and to wider concerns about short termism (ICAEW, 1997). Investors will be well informed about the possible risk factors and their impacts as well as management tools and techniques utilized to manage those risks. This will reduce information asymmetry and make the market perform better. Abraham and Cox (2007) claim that this information can help investors to determine the risk profile of a company and estimate its market value. So, rather than hiding it from the shareholders, it will a better practice by management to disclose the management techniques used to mitigate the impacts of risks.

However, risk reporting also has some obstacles. Risk reporting itself creates risks for the management. The lack of transparency of risk information is one of the main deficiencies of accounting and accountability reports that have been documented in risk reporting disclosure literature (Cabebo & Tirado, 2004). Dobler (2005) mentions uncertainty of managerial information availability and verifiability is a problem of risk reporting. Preparing risk information is not cost free. There are two types of costs related to risk reporting: proprietary and non-proprietary cost. Non-proprietary cost includes the cost of collecting, processing, retrieving and disseminating information. If the costs of collecting, processing and disseminating risk information exceeds the benefits expected form risk disclosure then management may refrain from making risk information publicly available.

Different strands of theory have been proposed to explain why companies disclose risk information (Linsley & Shrives, 2000). These theories are: a) Economic theory and b) Social and political theory. Economic theory approaches rely on positive accounting theory, which is based on the self-interest and profit maximization of economic agents. Positive theories of accounting aim to explain and predict accounting phenomena; therefore they attempt to describe ‘what is’ rather than prescribing ‘what should be’ (Deegan and Unerman, 2006). The theoretical frameworks used commonly to explain motivations for risk disclosure are agency theory, political costs theory, signalling theory, and proprietary costs theory. The social and political theory approach argues that it is necessary to consider the political and social relationships between company and society. Under this approach, the theoretical frameworks used for risk disclosure are stakeholder theory and legitimacy theory.

Total thirteen hypotheses have been developed related to firm specific characteristics and corporate governance characteristics. The name of the variables that have been used in this study: Firm size, firm performance, firm’s risk level, dual listing, ownership pattern, board size, board independence,
independence of the board of corporate auditors, committee system and board experience. Content analysis has been performed to collect necessary data for this research. Two indices have been constructed to measure the quantity and quality of risk factors disclosed. Risk Disclosure Quantity (RDQ) index consists of 80 risk factors under six categories to measure the nature and type of risk factors. This index will also help to compare risk disclosure practice among the companies and industries. Risk Disclosure Quality Score (RDS) index measures the quality of risk information based on four characteristics and different weights assigned to each characteristics. This index will allow to measure the decision usefulness of risk information disclosed by the companies and compare industry to industry.

Secondary data has been collected from 185 non-financial companies included in the JPX-Nikkei 400 index which disclosed English Annual Report (in some cases, from Annual Securities Report, Form 20F or website) for the years FY 2009 to FY 2014. Firm specific and corporate governance specific data was collected from Nikkei NEEDS-Cges Database. In the first phase, the type, volume and quality of voluntary risk disclosure over the year and industries have been analysed. In the next phase, relationship of firm and corporate governance related characteristics with RDQ and RDS have been analysed.

A variety of statistical methods have been used to analyse data such as Univariate, Bivariate and multivariate analysis. Pearson’s pairwise correlation, Spearman’s pairwise correlation and Partial correlation have been used to check the association between variables and to assess potential collinearity problem. In the multivariate analysis, dependent variables (RDS and RDQ) are regressed with independent variables (firm specific and corporate governance specific). In addition, one way ANOVA test, two sample t test, box plot graph and Wilcoxon rank sum test have been utilized to check the robustness of results.

Companies are found to prioritize operation related risks and financial risks in disclosing risk information to the shareholders which supports the findings of Konishi and Ali (2007). Among total 80 risk factors included in RDQ index, companies disclosed natural disaster and other events related risks for the highest time followed by laws and regulations related risks and exchange rate/foreign currency related risks respectively. After the incidence of Great East Japan Earthquake and Tsunami in 2011, most of the companies started to disclose natural disaster related risks and subsequently shortage of power supply related risks.

Companies have been found to improve the number of risk information in annual reports consecutively. On an average, 1,001 company year observations disclosed 13,141 risk factors in total and 13.12787 risk factors on average. However, quantity is not an appropriate proxy of quality. So, increasing number does not ensure quality of risk information. A Risk Disclosure Quality Score index has been used to measure the quality of risk information provided and found that companies like to improve quantity
rather than quality. Per company RDS was found 28.53946 point for 13.127872 risk factors which clearly indicates that companies like to give very ambiguous description of the impact of risk factors. Companies like to give basic description about the impacts of risk factors on the business performance without providing specific risk management technique and sharing any past experience. Information mostly are qualitative in nature. Very few risk information, mainly litigation related risks and foreign exchange rate related risks are quantified.

Significant differences have been found among practices of disclosing risk information between the industries and also within the industries. For example, Yahoo Japan Corporation under Information processing and Communication industry disclosed the highest number of risk factors and got the highest score in RDS calculation whereas Otsuka Corporation from the same industry disclosed the lowest number of risk factors and RDS point was also the lowest. So, political cost theory is not applicable in describing the risk disclosure practice in Japan.

The most common factor which the almost all of the companies disclosed is the “Impact of natural disasters, wars, terrorism, influenza and other events” related risk. The finding indicate that Japanese companies like to give top priority on disclosing natural disaster related risks as they think it most important in doing business in Japan. In addition, most of companies are engaged in importing raw materials and exporting finished goods. So they emphasized on disclosing foreign currency fluctuation related risks.

In case of measuring the quality of risk information, it has been found that companies mostly like to give basic description of the risk factors rather than detailed description or very detailed description. Among the total 13,141 risk factors, companies gave basic description for 6,856 risk factors which represents 52.17% of total risk factors. Detailed description has been given for 4,763 risk factors which is 36.25% of total risk factors. In case of disclosing the risk management techniques used by management for reducing the impacts of risk factors on the business operations, management behaved reluctantly to make the information publicly available. No description has been given about the risk management techniques for 7,631 risk factors which represents 58.07% of total risk factors. Basic description about risk management techniques has been given for 2,974 risk factors (22.63%) and detailed description has been given for 2,106 risk factors (16.02%). Only 430 (3.27%) risk factors have been equipped with very detailed risk management techniques. Only 773 risk factors have been quantified among total 13,141 risk factors. It has been found companies like to quantify foreign exchange related risk and litigation related risk mostly. In addition no experience has been shared by the companies for 12,400 (94.36%) risk factors. Only 741 risk factors have been equipped with experience. Mostly, impact of Great East Japan earthquake & tsunami and litigation related experience have been shared by the companies.
It has been found that companies from Information processing and Communication industry and Electric Appliances give emphasize on quality of risk disclosure. On the other hand, companies mainly from Machinery industry are found reluctant to provide quality risk disclosure.

Regression analysis shows that firm size, dual listing character, CEO’s shareholding ratio, board independence and committee system characteristics have significant positive impact on improving the volume of risk factors disclosure. On the other hand, major shareholders’ shareholding ratio has significant negative relationship with risk factors disclosure. Firm performance and risk level have no significant impact on volume of risk disclosures. Again, foreign shareholders’ shareholding ratio, board size, independence of Board of Corporate Auditor and board experience also do not have any significant impact on increasing the volume of risk factors disclosure.

On the other hand, in case of RDS, OLS regression results shows that firm size, dual listing character, CEO’s shareholding ratio, non-executive outside directors’ ratio, outside auditors’ ratio and committee system characteristics are found to have significant impact on improving risk disclosure quality whereas institutional shareholders’ & major shareholders’ shareholding ratio and board experience indicate negative impact on improving the quality of risk disclosure. These all results are supported by the regression with standard error but regression with standard error clustered at firm level confirm that only firm size has significant positive impact on improving the quality of risk disclosure. So, only big firms disclose quality risk information to reduce the agency cost and to give signal to the market about their better risk management abilities.

The findings of this research support the concept of agency cost theory, political cost theory, proprietary cost theory and stakeholder theory.

This study contributes to the disclosure literature, risk disclosure literature and corporate governance literature by examining the risk disclosure practice in terms of quantity and quality of risk information and finding association with firm specific and corporate governance specific characteristics.

This study has developed a risk disclosure quantity (RDQ) index which consists of 80 risk factors under six different categories. Management may consider the risks factors included in this index to disclose if these risks are applicable to their firms. Although it is difficult to develop a universally accepted risk disclosure index, but this index may guide the management to check whether these risk factors are applicable to them or not and then decide to disclose.

The research has also developed a quality risk disclosure (RDS) index which consists four characteristics that a risk factor information should contain. These characteristics are: Description about the impacts of risks; information about risk management technique, quantify the information if possible and share past experience (if any). When management will disclose risk information to the users, they can consider these characteristics to make the risk information more useful to the users and to reduce information asymmetry. When the users will have full information about the future prospects of the
business along with the possible factors that may hamper the performance, then investors will behave more efficiently and market will be less sensitive to risk information if any risk occurs to the company suddenly.

There are some limitations of this study. These are: a) only English Annual reports/Annual securities reports/ Form 20F were considered for data collection. So, sample size is not up to mark. Though most of the Japanese companies disclose risk information in Annual Securities Report in Japanese, this researcher is not expert in Japanese to read those reports; b) Due to language problem and time limitation, data were collected only from 185 companies out of 400 companies in JPX-Nikkei 400 index. Again, all the companies did not disclose risk information in English in each year. So, this researcher could not get balanced data for the time period; c) Subjectivity in the one of the major limitations of this type of research. However, proper cautions have been taken and coding rule have been strictly followed to overcome this problem and d) only voluntary risk disclosure practice has been considered in this study. However, inclusion of mandatory risk information might change the conclusion drawn in this research.