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The value relevance of risk disclosure in annual reports: Evidence from MENA emerging markets

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ABSTRACT

Our paper aims to examine whether voluntary risk disclosure in the annual report contains value-relevant information for investors to predict future earnings. We used a large-scale sample firms from MENA emerging markets. Our sample includes 809 year-observations for the 3-year period, 2007–2009. Our study offers two significant contributions. First, we found a positive relationship between voluntary risk information and the market's ability to anticipate 2-years ahead future earnings change. The positive association provides us with the first empirical evidence of the usefulness of risk disclosure in annual reports. Second, we found that the level of proprietary costs tends to moderate the perceived relevance of risk information, thereby making investors rely on another source of information in forecasting future earnings change.

1. Introduction

Accounting information has been considered as one of the fundamental pillars contributing to good corporate governance (Healy and Palepu, 2001). As owners delegate most of their decision making

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responsibilities to managers, agency conflicts arise between insiders and outsiders. Basically, managers are more informed about corporate business than investors. The availability of information is essential to reduce the information asymmetry between both sides. It plays an important role in the individual and corporate decision making process (Bogdan et al., 2009). Firm's reporting activity is expected to provide users with a great insight into the amounts, timing, and uncertainty of its future cash flows (Financial Accounting Standards Board, 2010) and adequate disclosure helps to ensure the efficiency of capital markets.

With the increasing complexity of business operations, stakeholders' needs of information have become more sophisticated. Society and standard setters, now, require a higher level of information, specifically, from publicly traded companies. The unexpected successive collapses of large firms with a biased image of being low risk and highly predictable (e.g., Enron) put into question the scope and the usefulness of corporate disclosure. This situation compelled accounting regulators to rethink the set of requirements for financial reporting. Meanwhile, there were considerable calls by academics, accountancy bodies and regulatory agencies for enhanced and understandable information about corporate prospects and business uncertainties (Deumes, 2008). As a result, narrative risk disclosure became increasingly required in periodic reports by national GAAPS or formal codes of best practice in corporate governance worldwide. Many developed countries such as USA, Canada, Germany, UK, Austria and Finland, etc., mandate financial risk communication, however its current regulatory framework reveals a piecemeal approach, focuses, predominantly, on market risk associated with the use of derivatives (e.g., FAS 119, FAS 133, IAS 32, and IAS 39). In this regard, a wider set of risk reporting is hitherto not driven by rules and is offered on a voluntary basis.

The regulatory reforms supported by the stead debate among the professional accountancy bodies (e.g. ICAEW) and standard setters over the lack of transparency and clarity in corporate risk reporting triggered a research stream in accounting and related fields about firms' risk exposure, risk management, and their monitoring processes around the world (Dobler et al., 2011).

The reason for this interest is that information on the risks and rewards of a firm's business is becoming crucial for well-informed investors and for an accurate corporate valuation and investment decision (Fuller and Jensen, 2002). Narrative risk disclosure is expected to narrow the information gap between management and stakeholders about business uncertainties and opportunities. It may decrease the firm's perceived risk because enhanced information on corporate risk should result in a better assessment of the firm's future performance. Managers also benefit from their transparency about the underlying risks in their strategic goals. They may signal their quality in identifying and managing risk, hence differentiating themselves from other corporate managers who may be perceived to measure and report on risk less effectively (Elshandidy et al., 2013).

Despite the recent significant focus on examining risk disclosure, information on firms' risk exposure is still one of the most ambiguous areas of corporate disclosure strategy. In particular, we know too little about the value relevance of risk disclosure, though the recent debate about its inadequacy. Some scholars argue that, as it is, current risk disclosure does not contain reliable information, for it is, in most cases, left to managers' discretion, (Schrand and Elliot, 1998), others point to its lack of progress (e.g. Abraham and Shrives, 2014), and still others consider it unhelpful and devoid of real meaning (e.g. Campbell and Slack, 2008; Davies et al., 2010; Moxey and Berendt, 2008). These criticisms may be argued to be groundless, for they are not supported by any empirical evidence. The few existing studies, investigate, mainly, the information content of mandatory risk disclosures provided in line with the Securities and Exchange Commission's requirement FRR No.48. Firms are required to provide quantitative and qualitative information about exposure to market risk and to disclose how they account for derivatives (e.g. Rajgopal, 1999; Linsmeier et al., 2002; Jorion, 2002; Liu et al., 2004; Lim and Tan, 2007; Pérignon and Smith, 2010). Kravet and Muslu (2013) fill this gap in the literature by addressing how users' risk perceptions change around the filing dates in response to changes in textual risk disclosures. Their study provides evidence on the informativeness of narrative risk disclosures. Following Kravet and Muslu (2013), Campbell et al. (2014) show that risk factor disclosures are not boilerplate, but instead meaningfully reflect the risks a firm faces. They decrease the information