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Information asymmetry in disclosure of foreign exchange risk management: can regulation be effective?

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Abstract

A reduction in information asymmetry, and hence in the monitoring burden between agent and principal, is one of the aims of the regulation of financial reporting disclosure in active capital markets. Theoretical models of voluntary disclosure have sought to explain the persistence of information asymmetry in terms of the perceptions of those who supply information and those who use it in market decisions. In the late 1990s listed companies in the US and the UK implemented annual report disclosures to satisfy regulatory requirements for disclosure relating to foreign currency risk management. This paper presents empirical evidence of financial statement disclosure where the information asymmetry may be assessed by comparing *ex post* the explicit disclosure of information in the annual report with prior questionnaire responses from the same companies. It shows, through a two-country comparison, that disclosure regulations drawn up at similar times and with similar driving forces, can have a different impact in two different regulatory environments. Also, in both regulatory regimes a substantial element of information asymmetry remains, consistent with the expectations generated from the theoretical voluntary disclosure models. The paper concludes that regulation of qualitative disclosures, while taking heed of the market's requirements for information, has not yet found the mechanism whereby transparency is complete. © 2002 Elsevier Science Inc. All rights reserved.

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1. Introduction

A reduction in information asymmetry, and hence in the monitoring burden between agent and principal (Jensen and Meckling, 1976; Holthausen and Leftwich, 1983), is one of the benefits intended from the regulation of financial reporting disclosure in active capital markets (SEC, 1997). This paper focuses on the disclosure of foreign exchange risk management policies and instruments in the financial statements of UK and US companies. This issue has gained prominence due to the growth in use of derivatives by corporates (see, Grant and Marshall, 1997), the impact of volatile exchange rates, such as the aftermath of the 1997 South East Asian currency crisis and the well publicised corporate derivative disasters (see, McCarthy, 2000). Consequently, there has been considerable development of disclosure regulations in both the US and the UK during the 1990s. Modern finance theory would predict that profit maximising companies hedge risk exposures in an effort to reduce the costs associated with agency problems between shareholders and bondholders, financial distress and taxes (see, Smith and Stulz, 1985; Froot et al., 1993 and Main, 1996). It could therefore be expected therefore that companies may benefit from disclosing the fact that they are actively hedging foreign exchange exposures.[1]

The regulators in both countries have endeavoured to encourage companies to make qualitative disclosures to augment the quantitative information. It is not an easy matter to write regulations to encourage openness in qualitative disclosures. The question left in the mind of the reader is ‘How fulsome is this disclosure?’ The professional analyst may seek to probe further by enquiries and exploration in private meetings but for those reliant on information available in the public domain the question can not be answered other than by observing subsequent events.

Qualitative and quantitative disclosures relating to the management and the extent of foreign exchange risk in US listed companies have been explored by Roulstone (1999) and Wong (1999), both of whom find that the implementation of the disclosure regulations is lacking in clarity and transparency. They offer explanations in terms of the learning process and the limitations of using financial statement data as a proxy for corporate characteristics, but more fundamental explanations may lie in the theoretical models of information economics in situations where managers choose not to reveal the totality of their information endowment.

The research questions in this paper are intended to explore further the findings of previous empirical research and to offer explanations in terms of prior models of disclosure in corporate reports. They are:

1. To what extent do companies fail to report the full information endowment of management in respect of foreign exchange risk management?
2. What are the comparative findings in respect of major US and UK companies?
3. What explanations may be offered for failure to report the full information endowment?

When new regulations require qualitative disclosure, there is an element of variability in how the requirements are interpreted. To that extent the disclosures retain a voluntary aspect notwithstanding the mandatory status of the encompassing regulation. Qualitative disclo-