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The disclosure of risk in financial statements

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Abstract

The accounting information currently issued by firms is not wholly adequate when used for decision making purposes, and within that process, for forecasting, for which additional information on risks is required. Therefore a reform of the current framework becomes necessary. Within this reform an adequate scheme and typology for the risks facing firms must be established and a set of specific risk quantification models must be designed. This paper focuses on both issues, showing all the risks that can affect firms and proposing a quantification model for each one.

Keywords: Accounting information; Risk; Risk quantification models; Value at risk

1. Introduction

The lack of information on risks facing companies is one of the main weaknesses in the accounting information disclosed by firms. Nowadays, companies are obliged to issue few items of this kind of information. Thus, the International Accounting Standard Board (IASB, 1995, 1999), under rules IAS No. 32 and 39, and the Financial Accounting Standard Board (FASB, 1998), under rule SFAC No. 133 only establish the compulsory disclosure of market risks arising from the use of financial assets. Likewise, the SEC (1997) through its FFR 8, obliges listed companies to disclose the market risk arising from adverse changes in interest and foreign exchange rates, and in stock and commodity prices. However, the rules do not refer to any other risks affecting firms, such as non-financial risks and financial risks other than market risks. Therefore, if the present model of accounting information were to

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incorporate a new statement on company risks, this statement would overcome one of the main drawbacks of the present model revealed by external users, mainly investors (present or potential shareholders and lenders).

Before taking an investment decision (i.e., loan approval), investors must evaluate the information disclosed by firms in order to determine the level of risk they are exposed to. The investor will take this decision based on the values of the binomial "expected return and risk". Under the present model of accounting information disclosure, investors must work as outsiders, by interpreting this information and inferring company risk levels from it. Obviously, the disclosure of information about risk would improve this situation: the company, using internal data, would directly establish levels of the various risks it faces. This would greatly ease the task of the external user of accounting information when interpreting the risks of the company.

In this paper we set out the different risks affecting business activity. We classify them into two groups (financial and non-financial risks) and put forward a quantification method for each kind of risk. We propose the value at risk (VaR) as a suitable quantification method for most company risks. We consider the problems arising from the use of VaR with limited data, such as the characteristically small samples available in the context under analysis.

The rest of the paper is structured as follows: in the next section we analyse the background of the topic. The third section analyses two fundamental questions that must be answered before deciding on the disclosure of risk information: must this disclosure be compulsory? and what kind of risks must the company inform on? The fourth section proposes a quantification method for each of the company risks identified in the preceding section. In the fifth section an empirical application is undertaken and the final section summarises the main conclusions of the paper.

2. Background

Companies must make compulsory reports about their economic and financial situation. For this purpose, firms must prepare and disclose financial statements, which constitute the main channel of information on the company's situation to external users. In this way, the information becomes available to the external users, who will use it for economic decision making purposes.

According to FASB (1978), the main aim of financial information is to be of use to users when taking decisions. Accounting information disclosed by companies is employed by a range of users (investors, lenders, suppliers, competitors, managers, civil service) although, as stated by FASB (1978) and AARF (1990), investors, including lenders, are the main users, who need financial information to take the right investment decisions, after evaluating the economic and financial position of the company and its risk. Therefore, investors take their investment/disinvestment decisions by evaluating not only the return associated to a determined investment project, but also its risk. According to Cea (1992), given that the purpose of the information disclosed by firms is to assist its users in their decision making process, if information about risks is incorporated, the disclosed information will be closer to the decision models set out in financial theory.