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Corporate governance and risk reporting in South Africa: A study of corporate risk disclosures in the pre- and post-2007/2008 global financial crisis periods

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ABSTRACT

The 2007/2008 global financial crisis has reignited the debate regarding the need for effective corporate governance (CG) through sound risk management and reporting practices. This paper, therefore, examines the crucial policy question of whether the quality of firm-level CG has any effect on the quality and extent of corporate risk disclosures (CRD) in South Africa (SA) with particular focus on the pre- and post-2007/2008 global financial crisis periods. Using one of the largest datasets to-date on CG and CRD, from 2002 to 2011, and distinctively drawing on a multiple theoretical perspective, we find that CRD are largely 'non-financial', 'historical', 'good news' and 'qualitative' in nature over the ten-year period investigated. We also find that block ownership and institutional ownership are negatively associated with the extent of CRD, whilst board diversity, board size and independent non-executive directors are positively related to the extent of CRD. By contrast, dual board leadership structure has no significant connection with the extent of CRD. Our results are robust across a raft of econometric models that adequately address different types of endogeneity problems, as well as alternative CG and CRD proxies. Our findings are largely consistent with the predictions of our multi-theoretical framework that incorporates insights from agency, legitimacy, institutional, resource-dependence, and stakeholder theories.

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1. Introduction

Major corporate collapses in the 1990s/2000s, particularly in the developed economies of Western Europe and North America, highlighted the need for good corporate governance (CG) through greater corporate accountability, social responsibility, sound risk management, transparency and disclosure practices (Iatridis, 2010; King Committee, 1994, 2002; Mallin, 2002). The 2007/2008 global financial crisis has reignited the debate and, in particular, the effectiveness of corporate risk management and disclosure practices (Breitenfellner & Wagner, 2010; Iatridis, 2008, 2011; Walker Review, 2009). This paper, therefore, investigates the association between CG and risk reporting in the light of the 2007/2008 global financial crisis. Specifically, we utilise a natural and unique corporate setting in South Africa (SA), where recent CG disclosure policy reforms distinctively require corporations to provide more transparent information on a set of recommended good risk management practices to examine the motives for, and determinants of, corporate risk disclosures (CRD).

The past years have witnessed a surge of interest in the quality and extent of corporate risk practices (ASB, 2009; ICAEW, 2011). This development is not only caused by the increased multi-level pressure from various external and internal corporate stakeholders, including regulators and investors (Berger & Gleibner, 2006; Linsley & Shrives, 2006), but is also due to the apparent strategic implications for maintaining long-term sustainable corporate operations (Abraham & Cox, 2007; Bhimani, 2009).[1] In fact, as risk disclosure involves substantial costs relating to litigation, copyrights, competition, regulation and taxation (Greco, 2012; Lajili & Zeghal, 2005), it has been argued that in the absence of potential direct and indirect benefits rational managers will not voluntarily engage in CRD (Beretta & Bozzolan, 2004; Lopes & Rodrigues, 2007). Hence, within this perspective, managers may engage in comprehensive CRD for a number of strategic motives/reasons.

First, increased commitment to transparency and accountability through CRD can minimise agency problems (Holm & Laursen, 2007; Rajgopal, 1999; Schrand, 1997) by reducing information asymmetry between managers and corporate stakeholders (Jensen & Meckling, 1976;

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[1] Indeed, widespread public perceptions and limited anecdotal evidence suggest that poor risk management and CRD practices partly contributed to the 2007/2008 financial crisis (the so called "credit crunch") (Breitenfellner & Wagner, 2010; Pirson & Turnbull, 2011; SSG, 2009; Walker Review, 2009).

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Rhodes & Soobaroyen, 2010), and thereby enhance performance. Second, from institutional (DiMaggio & Powell, 1983; Scott, 1987) and legitimacy (Ashforth & Gibbs, 1990; Suchman, 1995) theories' perspective, engaging in greater transparency and disclosure practices through CRD can strategically enhance congruence of corporate goals and norms with those of society, which can facilitate sustainable corporate operations by improving corporate reputation and goodwill (King Committee, 1994, 2002). Third, stakeholder theory suggests that engaging in comprehensive CRD (Amran, Bin, & Hassan, 2009; Elzahar & Hussainey, 2012; Holm & Laursen, 2007) can be an effective strategy to gain the support of influential corporate stakeholders, such as regulators, investors, government and employees (Donaldson & Preston, 1995; Freeman, 1984; Freeman & Reed, 1983), who may be important to a corporation's ability to conduct economically viable operations (King Committee, 1994, 2002). Fourth, from a resource-dependence perspective, increased commitment to CRD (Oliveira, Rodrigues, & Craig, 2011; Pirson & Turnbull, 2011) can increase access to crucial resources, such as finance, by minimising capital and political costs through improved corporate image and reputation (Branco & Rodrigues, 2006; Pfeffer & Salancik, 1978). In short, greater commitment to transparent CRD practices could have significant investment (capital budgeting), financing (capital structure) and liquidity (working capital) implications by reducing agency and information asymmetry problems (Abraham & Cox, 2007; Beretta & Bozzolan, 2004; Botosan, 1997; Brown, Steen, & Foreman, 2009; Cabedo & Tirado, 2004).

Whilst a number of prior studies have focused on the drivers of, and reasons for, the occurrence and extent of CRD (Ahmed, Beatty, & Bettinghaus, 2004; Meier, Tomaszewski, & Tobing, 1995; Solomon, Solomon, & Norton, 2000), they appear to suffer from a number of limitations. First, existing studies have mainly examined how general firm characteristics, such as size and industry, drive CRD (Berger & Gleibner, 2006; Lajili & Zeghal, 2005; Raj & Handley-Schachler, 2009; Schrand & Elliott, 1998). By contrast, and despite suggestions that corporate disclosure decisions, including CRD, are largely at the discretion of corporate owners and boards (Beretta & Bozzolan, 2004; Michelon & Parbonetti, in press), studies investigating how a company's CG mechanisms may affect its CRD are generally scarce (Abraham & Cox, 2007; Elzahar & Hussainey, 2012; Oliveira et al., 2011), and particularly so in developing countries (Amran et al., 2009; West, 2000). This considerably limits our understanding of why and how CG mechanisms might promote or impede CRD. Second, most prior studies have focused narrowly on financial CRD, especially market risks (i.e., exchange/interest rates, and commodity/equity prices), financial derivatives/instruments, and credit risks (i.e., credit default) (Marshall & Weetman, 2008; Rajgopal, 1999; Schrand, 1997; Schrand & Elliott, 1998). In contrast, studies exploring non-financial CRD, such as business/operational and strategic risks, are generally rare (Beretta & Bozzolan, 2004; Brown et al., 2009; Linsley, Shrives, & Crumpton, 2006).[2] Third, existing CRD studies have mainly employed one year cross-sectional data (Abraham & Cox, 2007; Linsley & Shrives, 2006; Lopes & Rodrigues, 2007; Oliveira et al., 2011), with limited longitudinal analyses (Berger & Gleibner, 2006; Greco, 2012; Raj & Handley-Schachler, 2009), and thereby limiting our understanding of CRD behaviour over time. Crucially, there is a growing criticism regarding inadequate empirical evidence, and a general lack of critical academic reflections, on CRD in the period leading to, during, and after the 2007/2008 global financial crisis (Abraham, Marston, & Darby, 2012; ASB, 2009; Edkins, 2009; ICAEW, 2011; Linsley, 2011). Finally, and despite the increasing evidence that employing a multiple theoretical framework provides a richer basis for understanding and explaining corporate disclosures, including CRD (Branco & Rodrigues, 2008; Chen & Roberts, 2010; Oliveira et al., 2011), past studies are either ex-ante relying primarily on a single theoretical perspective (Amran et al., 2009; Edkins, 2009; Elzahar & Hussainey, 2012) or are predominantly descriptive in nature (ASB, 2009; Marshall & Weetman, 2008; Meier et al., 1995).

Given this background, this study attempts to overcome the limitations of existing studies in a number of ways, and thereby extend, as well as make a number of new contributions to the extant CG and CRD literature. First, we seek to specifically examine the extent to which a company's CG mechanisms (i.e., in terms of ownership and board characteristics) may affect its CRD. This departs from most past studies that investigate how general company features, such as size and industry influence CRD. Our contention is that in a competitive and information asymmetric market, whereby CRD have significant financial and non-financial cost implications, better-governed corporations need to distinguish themselves by credibly signalling their good governance, accountability and transparency qualities. One way by which better-governed corporations can distinguish themselves is to commit to higher levels of CRD (Beekes & Brown, 2006; Mallin, 2002). Second, and unlike existing one year cross-sectional studies, our study explores CRD over a long and recent period (i.e., from 2002 to 2011), and thereby allows us to distinctively shed crucial and timely empirical insights on CRD in the pre- and post-2007/2008 global financial crisis periods. Third, and distinct from most of the existing studies that have narrowly investigated financial CRD, we provide evidence regarding both financial and non-financial CRD. Finally, we examine the drivers of CRD from multiple theoretical perspectives. Given the different motivations for CRD (Amran et al., 2009; Oliveira et al., 2011), the study is distinguished from previous studies by its ex-ante exploration of a number of theoretical perspectives, including agency, institutional, legitimacy, resource-dependence and stakeholder theories, as providing the likely basis for understanding and explaining CRD in the particular context of SA.

As will be discussed further, SA provides an interesting and natural context where CRD can be studied. Following the collapse of apartheid in 1994, and similar to other Anglo-American countries, SA has pursued CG policy reforms in the form of the King Reports (King Committee, 1994, 2002). Distinct from other Anglo-Saxon countries, however, the reforms require firms to provide more transparent information on a set of recommended good risk management practices (Ntim, Opong, & Danbolt, 2012a,b). As such, our study context, allows us to explicitly investigate whether a company's CG structures affect its CRD practices, as well as the various motives that may influence such disclosures.

The remainder of the paper is organised as follows. The next section discusses CG and the risk reporting policy reforms pursued in SA. The following sections present a multi-theoretical framework for corporate risk disclosures, discuss the CG and CRD literature, outline our research design, and present the empirical analyses, with the concluding remarks containing a summary and a brief discussion of policy implications.

2. Corporate governance, risk reporting and the South African corporate context

A considerable number of global corporate failures in the 1990s/2000s emphasised the relevance of good CG, accountability, risk management, social responsibility, accounting transparency and disclosure practices (King Committee, 1994, 2002; Mallin, 2002). Consequently, CG policy reforms have been pursued in a large number of countries (see Aguilera & Cuervo-Cazurra, 2009). It may be observed that such CG reforms, especially those implemented in Anglo-Saxon countries have predominantly focused narrowly on financial aspects (Ntim et al., 2012a,b). However, CG reforms carried out in SA have explicitly focused broadly on both financial and non-financial aspects of CG, including risk management and reporting (Ntim et al., 2012a). Arguably, this

[2] This is partly due to the general lack of a comprehensive CRD framework (Abraham & Cox, 2007; Cabedo & Tirado, 2004), broadly reflecting the piecemeal/patchy approach to regulating CRD by the various national and international regulatory and professional accounting bodies, such as the International Accounting Standards Board, Securities and Exchange Commission, and EU (ICAEW, 2011; Linsley, 2011), nevertheless, it inevitably limits our understanding of the determinants of, and motivations for, CRD.

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