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EFFECTS OF MANDATORY IFRS ADOPTION ON FINANCIAL INSTRUMENT RISK DISCLOSURE: CASE STUDY FROM A DEVELOPING COUNTRY

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Abstract

By introducing IFRS 7, it is expected that the companies will offer to potential investors a better assessment of risks that the firms are exposed though including in its portfolio financial asset and liabilities (Armstrong, Barth, Jagolinzer, & Riedl, 2010). Starting from this point of view, in our paper, we analyse and assess the quality and the quantity of risk disclosure presented in the annual reports of the companies listed on Bucharest Stock Exchange.

Keyword: risk disclosure, financial instrument, IFRS 7, Romania

JEL Classification: G23, M41

I. Introduction

Reviewing the literature of the past 15 years, we can notice the growing tendency of attention granted to analyse the risk disclosure, especially after the global financial crises. Beretta & Bozzolan is drawing our attention that the quality of risk disclosure should be analysing through the quantity of information and, also, through the plurality (richness) of additional information. Linsley & Shrives includes in the category of risk disclosure that information which is informing the reader *of any opportunity or prospect, or of any hazard, danger, harm, threat or exposure, which has already impacted upon the*

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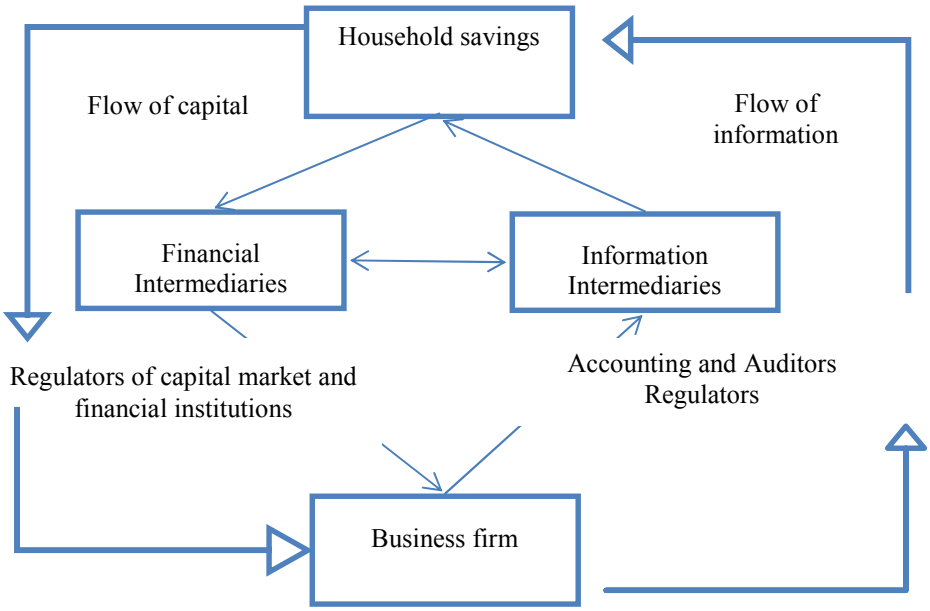
company or may impact upon the enterprise in the future or of the management of any such opportunity, prospect, hazard, harm, threat or exposure.

The information regarding the risks arise from the activity with financial instruments, is helping investors to improve their knowledge concerning the financial situation of the entities. Thus, the compulsoriness to offer disclosures about risks ensue from the changes in the financial and economic environment, especially regarding the interest, exchange, value fluctuations of shares and even the value fluctuations of the underlying asset. In this matter, the entities are obliged to offer information both about the financial risk that it's exposed, and non-financial risk (Cabedo & Tirado, 2003 studies the non-financial risk).

Figure 1 offers us a perspective on the role of disclosure and the financial intermediaries in an ideal working capital market.

Figure 1. Financial and informational flow in a capital market economy



Source: Adapted after Healy & Palepu, 2001

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The figure offers a perspective of the two actors present in any market: the offered and the receiver. A better communication between the parties through disclosing information about risk will lead to an improvement in exchanging information/capital.

II. Necessity of the study and database

Adoption of IFRS was a result of the need of a common language between the international companies and regarding that *accounting is the business language*, *and the businesses around the world do not afford to speak different languages while sharing and exchanging financial results* (Mirza & Hold, 2011) and being listed on the same stock market with international investors. Thus, this *accounting language universally applicable* (Dănescu, T., & Spătăcean, 2011) allows the companies not to limit themselves to the national level for search investors. In this matter, international financial users have the opportunity to invest in any company from which they think that can gain a maximum profit.

At Romanian national level, adoption of international standards was a long process, but a necessary one. For the first time, in Romania, adoption of international norms to national level was possible through OMFP 907/2005 *legal entities that apply accounting regulations in accordance with International Financial Reporting Standards, and accounting regulations compliant with European directives.* The decree states that starting with January 1, 2006; companies could elaborate their financial reporting by IFRS, but was not a compulsory measurement (OMFP.907/2005). From the listed companies at BSE in 2006, only two started to elaborate the financial reporting by the international standards.

In the process of proving the impact of adoption the international standards on risk arising from financial instruments, we considered the entries population of companies that are listed on BSE at 31st of March 2015, a total of 81 companies.

For forming and testing the theories proposed, from all 81 listed companies, we eliminated the financial institution and the international institutions (in total 12 institutions) because they have different particularities, and its aim can and should be studied in another research. Another 16 institutions were eliminated from our study because they had as elaborating data of the financial reporting different of 2012, so our total population was 52 companies for a 6 year (2009-2014). The financial reporting in the

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first 3 years of study was elaborated in accordance with OMFP 1752/2005 *regarding the approving accounting regulations compliant with European directives* and OMFP 3055/2009 *concerning the approving accounting regulations compliant with European directives* and for the last 3 years in accordance with OMFP 1286/2012 *approval of accounting regulations in accordance with International Financial Reporting Standards applicable to companies whose securities are admitted to trading on a regulated market*. The companies weren't classified into activities because we wanted to see the impact in the entire capital market and not specific to a sector, considering that the companies from the Romanian market is quite small, and we are not trying to exclude any relevant information.

III. Hypothesis

We enunciate the following assumptions:

Hypothesis 1. *The quality of risk disclosure regarding the financial instruments it is significantly higher in 2012-2014 in comparison with 2009-2011*

The transparency of information it is assured through different regulation that forms the informational politics in the company. The main goal of IASB it is to state the international financial reporting standards that contain detailed instruction regarding the aim of the financial reporting. These informational politics were made in the matter of erasing the discrepancy form by the informational asymmetry theory, especially after 1970 when the financial derivative evolution started and in the same time the risks register a grow as well.

In the literature, we can find studies that prove that not always a large quantity of information it is as well qualitative information. Abraham & Shrives shows us that the managers have a tendency of manipulating the information and „make-up" them to be more pleased for the investor, proving that managers do not want to disclose information that can be explored by the industry competitors.

In accordance with IFRS 7, the user should find a balance between the quality and the quantity level of information offers through the annual report, so we are expanding that in Romania to see a higher standard of disclosure after implementing IFRS.

Hypothesis 2: In the annual report we should observe a higher number in identifying the risk categories in the period post-IFRS in comparison with the period ante-IFRS

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Through this study, it is expected to notice an increasing in the numbers of risk categories arising from financial instruments. This expecting it is founded on the base of IFRS 7, taking into consideration that listed companies must disclose information about risk and how they are managing, but also to offer information about other significant financial risk that can influence the decision of the stakeholders. IFRS 7 identifies three main categories of risk: credit risk, liquidity risk and market risk (here we can include interest risk, exchange rate risk and other risk).

We are expecting to find that the total volume of disclose information about risk to be evenly distributed in different categories and that the level of disclosure of those to rise after the adoption of the international financial reporting standards.

Hypothesis 3. The size of the companies will have a superior level of the risk disclosure rating in 2012-2014 in comparison with 2009-2011

The size of the companies it is used in the literature as a proxy because it is proven that it can influence the company's police and the management. Lang & Lundholm, 1993, 1996 proves the link between the business's size and its performance (as can be seen in the study of Moumrn, Othman, & Hussainey, 2015) and the impact on the disclosed information. Most of the time, this variable it is taking into consideration for avoiding the problems resulted from the informational asymmetry theory or the agency theory. According to Watts & Zimmerman, 1990 the cost with informational disclosure are bigger with the large entities because they want to disclose more information with the aim of raising the level of trust for the company. The explanation to this theory it is that larger companies have superior informational systems, in comparison with small businesses, so they can obtain much more additional information without incremental costs (Atanasovski, Serafimoska, Jovanovski, & Jovevski, 2015).

Hypothesis 4. The quality of risk disclosure it is significantly higher to the companies audited by a Big 4 in comparison with the national audit network

The studies regarding the impact of international financial reporting standards adoption take into consideration and the existed relation between risk disclosure and the type of audit company that is making the auditing.

As the company has a bigger size it becomes more complex and diversified in offering products and services, making harder to manage the efficiency and the prevention of the risk managerial control system, and at the same time the responsibility of the auditor is increasing in verifying and certifying the financial reports.

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Jensen & Meckling, 1976 proves that entities that have bigger agency costs have the tendency to close more contracts with the audit companies that are considered quality. This trend explains the fact that the audit companies encourage the entities to have a better transparency in information and a higher level of disclosure. One of the explications of this fact, it is that the audit companies want to preserve its reputation (Oliveira, Lima, & Craig, 2011) and to avoid additional cost whit the marketing.

The link between choosing a Big 4 company and the rising of quality of disclosure it is explained through the fact that the international companies have better knowledge of the international accounting standards and the financial reporting, so the implementation cost and the auditing of them are smaller, in comparison with the small auditing firms (Teixeira Lopes & Lima Rodrigues, 2007).

IV. Research methodology and results

Determining the quality of risk disclosure was always a challenge for the researchers. The question that appears in this cases it is *how can we objectively measure the quality indicators (relevance, credibility, comparability and opportunity)?*. Van Beest & Braam, 2013 elaborate a measuring instrument of quality after the model from the international framework. In our paper, we used only 21 from all 33 indicators because our aim is to analyse the risk disclosure referring strictly to financial instruments. From all the documents of our companies, we analyse 2388 documents including financial statements, management report, report to BSE and audit report. We have to mention that the manually collected data was double-checked by two different persons.

The quality rating index analysed on the Van Best's framework it is calculated according to the following formula

$$QR=\frac{T}{M} \qquad (1)$$

Where:

QR=total score that an *j* entity can obtain in an *t* period, and $0 \leq QR \leq 1$;

T=total points that entity *j* obtain in the *t* period;

M=maximum points that entity *j* can obtain in the t period having the value of 105 (21 index x max 5 points).

The quality rating index it is based on an interval/report ratio. Different results of quality risk disclosure can be compared between them.

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For testing our second hypothesis, we will use a t-test. The results of each year will be calculated and used for making the comparison of ante-IFRS and post-IFRS. The hypothesis will be tested in a trust interval of 95%.

We will make a comparison between the mean of two different groups, resulting in two sub-hypotheses:

H_0: the mean of the two groups it is equal;

H_1: the mean of the 2012-2014 groups it is higher in comparison with the mean of 2009-2011 groups.

A new dummy variable was created IFRS, where 0= 2009-2011 period and 1= 2012-2014 period.

I.1. Hypothesis 1

It can be observed that the mean score of quality rating index it is 0,6578, with a standard deviation of 0,1219.

Table 1. Summarize of variable QualityRating

Variable	Obs	Mean	Std. Dev.	Min	Max
QualityRating	309	.6578517	.1219296	.247619	.9333333

In Table 2 we can see the result of the t-test for the variable QualityRating, where we can observe that the mean of group 0 it is 0,5855 and the mean of group 1 it is 0,7296. The t-test shows us that the value of t it is -12,8599 with a lever of trust of 0,000. Meaning that the mean score of our variable it is significantly higher in group 1 (at a trust interval of 99%) in comparison with group 0.

Table 2. T-test for variable QualityRating

Group	Obs	Mean	Std.Err.	Str.Dev.	[95% Conf. Interval]	
0	154	.5855906	.0088783	.1101774	.5680506	.6031306

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1	155	.7296467	.0068457	.0852277	.7161232	.7431702
combined	309	.6578517	.0069363	.1219296	.6442032	.6715003
diff		-.1440561	.0112019		-.1660984	-.1220138
diff = mean(0) - mean(1)				t = -12,8599		
Ho: diff = 0				degrees of freedom = 307		
Ha: diff < 0		Ha: diff != 0		Ha: diff > 0		
Pr(T < t) = 0.0000		Pr(|T| > |t|) = 0.0000		Pr(T > t) = 1.0000		

I.2. Hypothesis 2

A total number of risk categories will be evaluated, also, on an interval/report ratio. The total number of risk categories identified by IFRS 7 it is split to the total number of identified risk categories found in each annual report. The results will be compared between the two groups. For testing our hypothesis, we will use a t-test and will be calculated to a trust interval of 95%.

It can be observed that the mean score of quality rating index it is 0,4782, with a standard deviation of 0,2168.

Table 3. Summarize of variable RiskCateg

Variable	Obs	Mean	Std. Dev.	Min	Max
RiskCateg	309	.4782452	.2168733	.1111111	1

In Table 3 we can see the result of the t-test for the variable QualityRating, where we can observe that the mean of group 0 it is 0,4752 and the mean of group 1 it is 0,4812. The t-test shows us that the value of t it is -0,2417 with a lever of trust of 0,05. Meaning

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that the mean score of our variable it is not significantly higher in group 1 (at a trust interval of 95%) in comparison with group 0, so we have to reject the hypothesis.

Table 0. T-test of variable RiskCategory

Group	**Obs**	**Mean**	**Std.Err.**	**Str.Dev.**	**[95% Conf. Interval]**	
0	154	.4752688	.0177486	.2209689	.4402066	.5103311
1	155	.481241	.0171923	.2133506	.4472761	.5152059
combined	309	.4782452	.0123375	.2168733	.4539688	.5025217
diff		-.0059722	.0247129		-.0546003	.042656
diff = mean(0) - mean(1)				t = -0.2417		
Ho: diff = 0				degrees of freedom = 307		
Ha: diff < 0		Ha: diff != 0		Ha: diff > 0		
Pr(T < t) = 0.4046		Pr(|T| > |t|) = 0.8092		Pr(T > t) = 0.5954		

I.3. Hypothesis 3

The size of the company it is measured in 3 different ways: market capitalization, net turnover and total assets. Like the other variables, the size of the company it is measured on a ratio scale: interval/report. In this hypothesis, for determining the correlation between the variables, we will use Pearson correlation. For testing hypothesis 3, Pearson correlation coefficients will be calculated to a trust interval of 95%, so we have two sub-hypothesis:

H_0: there is a significant correlation between variable X and Y (α=0,05)

H_1: there isn't any significant correlation between variable X and Y (α=0,05)

Where X = size of the company and Y = risk disclosure rating

For testing the hypothesis according to which there is a close correlation between the quality of information and size of the company, we will perform Person correlation test, as it can be seen in Table 5.

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Table 5. Pearson correlation test for hypothesis 3

Ifrs=0				
	Qualit~g	**Ln_TA**	**Ln_NT**	**Ln_Cap**
Qualit~g	1.0000			
Ln_TA	0.1960 0.0148	1.0000		
Ln_NT	0.0920 0.2564	0.7790* 0.0000	1.0000	
Ln_Cap	0.1187 0.1426	0.7812* 0.0000	0.7317* 0.0000	1.0000
Ifrs=1				
	Qualit~g	**Ln_TA**	**Ln_NT**	**Ln_Cap**
Qualit~g	1.0000			
Ln_TA	0.3225* 0.0000	1.0000		
Ln_NT	0.2883* 0.0003	0.7820* 0.0000	1.0000	
Ln_Cap	0.3476* 0.0000	0.7798* 0.0000	0.7608* 0.0000	1.0000

*correlation it is significant to a level of 0,05

As we can see, Pearson correlation test for group 0 is telling us that there is not any significant level between the variables, and the relation between them being non-linear.

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For the second group, Pearson correlation test shows us a positive relation between risk disclosure quality and company's size, when the value of p=0,05. When we test the hypothesis to a linear test, we observed that there is not any linearity relation between variables, there is grouped into a cluster, resulting into a not so strong correlation between variable. So, we cannot confirm our hypothesis.

I.4. Hypothesis 4

The companies were classified after the type of the audit firm in authorized person, audit firm non-Big4 and audit firm Big 4. The quality of disclosure it is measured on an interval/report ratio. In this hypothesis for determining the correlation between the variable, we will use Pearson correlation test, at a trust interval of 95% stating the same sub-hypothesis from hypothesis 3.

The Pearson correlation test can be seen in Table 6.

Table 6. Pearson correlation test for hypothesis 4

Ifrs=0				
	Qualit~g	**PF**	**SRL**	**Big4**
Qualit~g	1.0000			
PF	-0.0921 0.2559	1.0000		
SRL	-0.1545 0.0557	-0.4454* 0.0000	1.0000	
Big4	0.2301* 0.0041	-0.1547 0.0553	-0.8156* 0.0000	1.0000
Ifrs=1				
	Qualit~g	**Ln_TA**	**Ln_NT**	**Ln_Cap**
Qualit~g	1.0000			

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Ln_TA	-0.1779* 0.0268	1.0000		
Ln_NT	-0.1444 0.0731	-0.4703* 0.0000	1.0000	
Ln_Cap	0.2917* 0.0002	-0.2242* 0.0050	-0.7546* 0.0000	1.0000

Pearson correlation test is proving that the hypothesis stated that there is a connection between the audit firm and the quality of risk disclosure has a significant link. The significance level it is valid only if the classification of the audit companies it is made in two categories: audit firm of Big4 and audit firm of non-Big4.

We can notice that our hypothesis can be accepted in the case of both groups' ante-IFRS and post-IFRS, but it cannot confirm the hypothesis according to which there is a significant level if the non-Big4 audit companies it is classified into authorized person and audit firm non-Big4.

V. Conclusion

The aim of this study was to expand the empirical knowledge regarding risk disclosure of financial instruments, existed in the literature. This study examines the quality of information in the matter of risk disclosure of financial instruments in the annual reports of 52 non-financial companies, for a six years period. The study tested the connection existed between the quality and company's size and the relation between quality and time.

The research results maintain the hypothesis according to which there is a positive relation between quality of risk disclosure and the time variable. We could observe that the quality of information regarding financial instruments was significantly higher in the post-IFRS period in comparison with an ante-IFRS period, confirming the researchers of Van Beest & Braam, 2009, 2013.

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After the analysis made, we cannot confirm that there is a positive correlation between the categories of risk and the time variable. We can notice that the number of risk categories presented in the annual reports were almost the same in the period analysed, confirming the studies made by Liu (2006), but invalidating the results of Beretta and Bozzolan (2004) and Linsley and Shrives (2006).

Analysing the relation between quality of risk disclosure and company's size, we could observe that there is a positive correlation for the post-IFRS group. However, the same hypothesis cannot be confirmed for the ante-IFRS group. We can declare that the quality of risk disclosure is not dependable on variable company size, confirming the research of Beretta and Bozzolan (2004).

Last, but not least, the result of the research can confirm the hypothesis that there is a correlation between the audit company and the quality of risk disclosure. The condition that it is applied in this situation is not to classify the audit companies into 3 categories, only in two: audit firm Big4 and audit firm non-Big4, in this matter confirming the research of Atanasovski et.al. (2015).

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