CHAPTER I

INTRODUCTION

A. Background of Research

In last decades, the development of world is changing when humans find sophisticated technology as their new invention and many opportunities to make the businesses going smoothly. However, the dynamics of global economy give result into uncertainty that arises along with business risks. When the uncertainty is getting bigger, the risk is bigger too. The cause of global crisis can be uncertainty and it already happened in United States because of subprime mortgage. The global financial crisis that started as a credit crunch in July 2007 in the U.S. was the most serious setback the world economy has experienced since the great depression have spread to other countries and brought the financial system to a halt (Kenc and Dibooglu, 2009). No one can expect one of developed countries was hit by the crisis and the impact crashed into the global crisis in 2008. Risks rise unexpectedly and unanticipated.

A growing demand for better reporting of business risks has emerged in recent decades (ICAEW, 2011). The reason why risk management needed is to estimate losses of financial institutions in presence of global economy. Risk management is really needed to manage the loss because of anticipated risks and unanticipated risks. These risks are unavoidable and only can be managed and minimized. Risks happen because of the market volatility and it influences other markets. It impacts for investors distrust and stakeholders ask the companies to disclose information to annual report. Risk reporting has been demanded by investors and other parties and has become important role. There is the belief that improved understanding of business risks by investors and other users of corporate reporting should lead to better stewardship of companies and to a more efficient allocation of resources (ICAEW, 2011).

Annual report is mandatory document that should be reported every year by the company to provide useful information to users. It has financial statement and non-financial statement to give useful information toward investors and stakeholders. However, financial statement does not stand alone in this case. There are many cases which involved scandal and manipulation of accounting practices. For an example, the case of Enron and WorldCom has resulted investors distrust and the impact is a growing demand of disclosing more information about the company. After the Enron and WorldCom's largest fraud in U.S. history, corporations has intensified the focus on continuous assurance as a viable enterprise risk-management tool to improve the audits (Kuhn and Sutton, 2006).

Investors doubted the numbers of accounting that appear in the annual report and it is lack of transparency to expose the company's condition. Furthermore, future risks and irrelevant results will appear if it is not being disclosed. Users require stewardship and decision-making purposes to improve narrative risks, reporting to ensure that key information about business is disclosed in the annual report (Abraham et al., 2012). The amount of information disclosed by public listed companies has increased substantially over the past the past few years, partly due to regulation and partly due to the increase in voluntary information provided by these companies (Campbell and Slack, 2008 in Abraham et al., 2012).

Among the many new areas of interest that require disclosure in the annual report are matters relating to social and environmental obligations and the intellectual property of the company (Amran et al., 2009). It is related with company issues about accounting matters that lead to the disclosures.

Risk is the chance of making a loss (Gibson, 2003). Every decision involve element of risks. Therefore, debate on the importance of risk reporting commenced as early as 1998 when the Institute of Chartered Accountants in England and Wales (ICAEW) published a discussion paper entitled "Financial Reporting of Risk – Proposals for a statement of Business Risk" (Amran et al., 2009). According to Amran et al. (2009), discussion on risk management and its requirement in Malaysia for disclosure can be explicitly found in the Financial Reporting Act 1997 and Bursa Malaysia listing requirements which stipulate that the company is required to disclose its financial position, management, and operations in order to enable shareholders and investors to assess its performance for the financial period.

Risk-related disclosures have to be used as decision-making tools accurately. Ismail et al. (2013) did the research that the FASB (2001) Steering Committee demonstrated this when it reported that the information that users are most looking for from the annual report includes (1) more disclosure of non-financial information, (2) more forward-looking information, and (2) more information about tangible asset. Their research emphasized on how importance risk management disclosure is. There is IFRS 7 Financial Instruments: Disclosures from IAS which requires disclosure of information about the significance of financial instruments to an entity, and the nature and extent of risks arising from those financial instruments, both in qualitative and quantitative terms, so the specific disclosures are required to the transferred financial assets and a number of other matters.

Stakeholders require disclosure to implement good corporate social responsibility, good corporate governance, and enterprise risk management. Risk management disclosure is very important to be discussed in MDA (Management's Discussion and Analysis) because ineffective risk management can lead to reduced earnings and maybe bankruptcy (Lam, 2003, pp. 4). Good risk disclosure assists to enable the investors evaluating the quality and prospective volatility of company earnings and cash flows and also enable the investors to assess a company's ability to respond the risks (CICA, 2004). Caruana (2011) as the General Manager of Bank for International Settlements (BIS) recognized the transparent disclosure is good for markets, because it helps the investors to make more informed decision; it is good for prudential supervision, because it helps to make banks more accountable, both to supervisors and investors; and it is good for the stability of the system as a whole, because it reduces the chance that unexpected events will cause major system-wide disruptions.

The importance of risk reporting brings to the regulators to issue the regulation of risk reporting in the annual report. In Indonesia, there is regulation about risk disclosure in Exposure Draft PSAK No. 60 (Revision 2010) issued on May, 2010 about Financial Instrument: Disclosures. It provides the information about the significance of financial instrument for financial position and performance; and the information about characteristics and risk level from financial instrument. Other regulation supports the disclosure with the Decision of Bapepam Chairman and Financial Institution No. Kep-431/BL/2012 issued on August, 2012 about Submission of Annual Report Issuer or Public Company. It considers that the annual report of issuer and public company is important source of information about prospect and performance of company for stakeholders as one of basic considerations of investment decision making. For banks, there is Regulation of Bank Indonesia No: 14/14/PBI/2012 about Transparency and Publication of Bank Report. It considers that to create market discipline and to get along with development of international standard, improvement of financial condition transparency and bank performance are needed through bank publication report to ease the assessment of public and market participants; to create the transparency, bank should provide quantitative and qualitative information to ease the information users to assess financial condition, performance, risk profile, implementation of bank risk management and business activity include determination of interest rate; disclosing the information to the public to provide the transparency of financial condition and bank performance needs to notice the competition factor between banks; and to gather comprehensive information and to get along with the implementation of bank consolidated supervision required the report on financial condition of parent company, subsidiaries, affiliates and related parties.

From previous studies, disclosures level is found to be positively related to 'company size' (Amran et al., 2009; Abraham and Cox, 2007; Aljifri, 2008; Oliveira et al., 2011; Linsley and Shrives, 2006; Meijer, 2011). Meijer (2011) examined the quality and quantity of risk disclosures in annual reports of 31 non-financial listed companies in the years 2005, 2006, 2007 and 2008; and the study tested for relationships between the quantity and company size, the quality and company size and the relationship between quantity and time and quality and time. Based on Linsley and Shrives's research (2006), risk sample of Canadian and UK bank annual reports were examined and five hypotheses which were tested, two of them were rejected; and the two rejected hypotheses suggest that there does not appear to be an association between levels of risk disclosure and either bank profitability or the level of risk within the bank. Höring and Gründl (2011) investigated risk disclosures practices in annual reports of European insurers listed on the Dow Jones Stoxx 600 Insurance

Index and they developed hypotheses such as risk disclosure and size, risk, profitability, ownership dispersion, listing status, home country, bancassurance activity, and one of business type. For Indonesian case, there are some researchers who examined risk disclosures. Taures and Daljono (2011) investigated the relationship between company characteristics and risk disclosure in the annual report of non-financial companies listed on Indonesia Stock Exchange in 2009; and the researcher developed hypotheses about product diversification, geographical diversification, company size, type of the industry, leverage, profitability toward risk disclosure. Rahajeng and Marsono (2010) examined the influence of company's characteristics (public ownership, size, profile, liquidity, profitability and solvability) toward corporate social responsibility of Indonesian manufacturing companies. Suhardjanto et al. (2012) identified the role of corporate governance in risk disclosure practices of Indonesian banking industry that the corporate governance influenced the level of risk disclosure (variables that influencing are board size, number of board commissioners and leverage) and the mean of risk disclosure level is 51.42% which means that the level of risk disclosures in the annual report in Indonesia is still low, considering bank risk disclosures is one of mandatory disclosures (written in PBI No: 5/8/PBI/2003, PSAK (2006) and P3LKEPPBANK (2008)).

The researches explain that risk disclosures between banks, insurance and non-financial companies are different, even though the developed hypotheses are same. In general, risk disclosures in the annual reports from other countries already increased with the extent of disclosures and the global financial crisis. Financial crisis started on 2007 when the financial giants such as Bear Stearns, Lehman Brothers, Merrill Lynch, AIG, Fannie Mae, Freddie Mac, and Citigroup have either disappeared or been rescued through large government and caused the worst recession (Jones, 2009), so this study chose 5 years period to determine the level of risks in Indonesia as OECD that get the impact after the starting financial crisis. The study of risk reporting in Indonesia should be examined deeper by choosing manufactures. When ASEAN Free Trade Area (AFTA) and Asia-Pacific Economic Cooperation (APEC) are formed as the international trade and economic globalization, the globalization will open the new nuances in economic relations across the countries and for this case the high risks of Indonesia will increase. It happens because at the same time, they must anticipate the negative impact and have opportunities of the developments. The one who having a competitive advantage is a manufacturer than the others because the goods produced have advantages over other similar products (Robertua, 1995 in Saleh and Suprayitno, 2010). In free trade and economic globalization perspective, the manufactures get the most attention from the investors when the mobility of production cannot be separated along with the capital to support the trade (Saleh and Suprayitno, 2010). For the evidence of Indonesian manufacture's development, national manufactures reached 6.40% in 2012 because higher investment in industry and consumption sector within the country (Majalah Industri, 2013). Therefore, the topic of risk disclosures in the annual report by focusing on the Indonesian manufacturing industries listed on Indonesia Stock Exchange period 2008 until 2012 needs to be examined.

B. Problem Statements

Based on the research background above, the author formulates the following issues:

1. How company size, type of industry, leverage, profitability and liquidity can potentially influence the level of risk disclosures of 30 manufacturing companies listed in Indonesia Stock Exchange?

C. Research Scope

In order to avoid this research get complex and to obtain a clearer direction for this research, the author makes some limitations on the following issues:

1. This study analyzes the influence of company size, type of industry, leverage, profitability and liquidity toward the level of risk disclosure.
2. Data of 30 manufacturing companies listed in Indonesia Stock Exchange using Indonesian Rupiah year 2008 to 2012 (5 years), based on annual report and financial report which can be obtained from IDX,

Indonesia Capital Market Directory (ICMD) and the companies' personal website.

3. The result will be conducted to assess the level of risk disclosure of 30 Indonesian manufactures period 2008 until 2012 to ensure the companies already disclose the risk information as it should be written in the annual report.

D. Research Objectives

This research has some objectives, such as:

1. To analyze the influence of company size, type of industry, leverage, profitability and liquidity toward the level of risk disclosures of 30 Indonesian manufacturing companies period 2008 until 2012.

E. Research Benefits

Benefits of the study are:

1. For the readers

   This research is expected as a reference for the readers to have better understanding and broader knowledge of risk reporting of manufacturing companies by using annual report of the companies.

2. For the author

   This research is expected to give an insight for better understanding of risk reporting of manufacturing companies by using annual report of the companies. This study is important to be used as one of decision-making tools in future. The author also had an opportunity to apply the theories that have been obtained during lectures.

3. For the investors

   This research gives some information about the level of risk disclosures to help them for making consideration and decision to invest in manufacture industry.

4. For the other researchers

   This research can become reference in order to support their researches, especially to the topics that related with risk reporting in Indonesia.

F. Research Relevance

In this part of research proposal, the author discusses about what makes this research important and needs to be examined. In common understanding, risk is along with uncertainty since the development grows so rapidly and it triggers risks. Risk reporting becomes important issue to overcome the financial crisis because understanding the risks of corporate means good transparency of companies to be disclosed for the investors. One of the key requirements of risk management is that it should produce timely and relevant risk reporting for the senior management and board of directors (Lam, 2003, pp. 46). ERM can increase the implementation of good corporate governance and risk transparency of company. As written in the regulation about risk disclosure in Exposure Draft PSAK No. 60 (Revision 2010) issued on May, 2010 about Financial Instrument: Disclosures and the Decision of Bapepam Chairman and Financial Institution No. Kep-431/BL/2012 about Submission of Annual Report Issuer or Public Company that the annual report of issuer and public company is important source of information about prospect and performance of company for stakeholders as one of basic considerations of investment decision making. Therefore, risk management disclosure of manufacturing companies is important to acknowledge the company prospect and performance as the consideration.

G. Research Report Outline

For the ease of understanding in this research, the author makes a design of the research that consists of:

Chapter I: Introduction

This chapter provides the introduction about the research that consists of background of research, problem statements, research scope, research objectives, research benefits, research relevance and research report outline.

Chapter II: Theoretical Background

This chapter contains the theoretical background that related to this study and literature review.

Chapter III: Research Methodology

This chapter describes the population and sample used in this research, type of methodology, data sources and data gathering, variable and variable measurement, and method of analysis.

Chapter IV: Data Analysis

This chapter provides the data analysis and explains the result obtained in this study.

Chapter V: Conclusion and Suggestion

This last chapter describes the final conclusions of the study, limitation of the research, and suggestions for further research.