CHAPTER II

THEORETICAL BACKGROUND

A. Literature Review

Amran, Bin and Hassan (2009) wanted to explore the availability of risk disclosures in the annual reports of Malaysian companies by focusing on the non-financial section of the reports. The total number of sentences dedicated for discussion of risk information by the sampled Malaysian companies is very much less when compared to the study done by other researchers. In their regression results, the size did matter and was proven significant. The nature of the industry was also found to influence the extent of risk disclosure. Industries with greater exposure to risks, such as the infrastructure industry, would have many more things to discuss. Their research contributed by providing an initial understanding of risk management disclosure practices in Malaysia.

Linsley and Shrives (2005) examined risk information disclosed by UK public companies within annual reports. The authors examined whether a relationship exists between company size or level of risk and risk disclosure totals. The results indicated that the samples did not provide complete picture of risks they face because there was minimal disclosure of quantified risk information and a significant proportion of risk disclosures consist of generalized statements of risk policy.

Hassan (2009) explored the relationship between the United Arab Emirates (UAE) corporations-specific characteristics, such as size, level of risk, industry type and reserves and level of corporate risk disclosure (CRD). The sample was 41 corporations consisting of financial and non-financial UAE corporations listed in either Dubai Financial Market or Abu Dhabi Security Market. The results were shown that corporate size was not significantly associated with the level of CRD, the corporate level of risk and corporate industry type were significant in explaining the variation of CRD. In contrast with reserves-CRD hypothesized relationship, corporate reserve was insignificant and negatively associated with level of CRD.

According to Vandemaele, Vergauwen and Michiels (2009) in their research, "Management Risk Reporting Practices and their Determinants", they examined the extent of risk disclosure in annual reports of Belgian listed firms and studied the firm and corporate governance characteristics that facilitate risk disclosure by management. The data used were 46 annual reports of Belgian listed companies of 2006. The result was the coefficient on company size is positive and significant, confirming the hypotheses that larger companies disclose more risk information. Association between profitability and risk disclosure was negative. The beta factor had positive significant relationship with the extent of risk disclosure.

Oliveira, Rodrigues and Craig (2011) assessed the risk-related disclosure practices in annual reports for 2005 of Portuguese companies in the non-finance sector. They conducted a content analysis of a sample of

42 listed companies. Their results supported explanations of RRD that are based on a combination of agency theory, legitimacy theory and resources-based perspectives and the adoption of high quality accounting standards (IAS/IFRS) did not render any improvement in the quantity of RRD.

Lajili and Zéghal (2005) examined risk information disclosures in Canadian annual reports to provide insights into the current risk disclosure environment, its characteristics, and the analytical usefulness of the information disclosed to the firm's stakeholders. They described and analyzed risk disclosures of TSE 300 Canadian companies and results showed a high degree of risk disclosure intensity reflecting both mandatory and voluntary risk management disclosures.

Fathimiyah, Zulfikar and Fitriyani (2012) researched the effect of ownership structure on risk management disclosure to banking industry that listed in Indonesia Stock Exchange year 2008 to 2010. The sample used was of 72 samples from 24 banks period 3 years (2008 to 2010) with multiplied analysis linear regression as the statistical method and hypotheses testing using of t-test and F-test. The result showed that management ownership, domestic institution ownership, foreign institution ownership and public ownership as the variables were simultaneously influence the risk management disclosure. From 72 samples of bank, the risk management disclosure level was 0.8090 or 8.09% by banks.

Therefore, the author wants to analyze risk reporting of 30 Indonesian manufacturing companies for year 2008 to 2012. The study

aims to examine the influence of company size, type of industry, leverage, profitability and liquidity toward the level of risk disclosure.

B. Theoretical Background

1. Stakeholder Theory

A stakeholder means many different things to many different people and evokes praise or scorn from a wide variety of scholars and practitioners of myriad academic disciplines (Phillips et al., 2003). Stakeholder can be stockholders, creditors, consumers, government, general public and all parties participated of a company. According to Phillips et al. (2003), stakeholder theory is a theory of organizational management and ethics.

Communication with company stakeholders is one of the most important and sensitive as the responsibilities of the board of directors because corporate governance codes say that management should speak for the company and the board has a key role in disclosing certain types of information (Lam, 2003, pp. 60).

2. Agency Theory

Agency theory has been concerned with the relationship between managers and stockholders (Hill and Jones, 1992). Agency theory explained how information asymmetry between shareholders, managers and creditors can be reduced by monitoring the

opportunistic attitudes of managers (Jensen and Meckling, 1976 in Oliveira et al., 2011). Whenever one party (the principal) hires someone else (the agent) to work for him or her and the agent is always supposed to act in the principal's best interest (Cornett et al., 2009, pp. 15).

The managers operate the firm so the shareholders can maximize the value of their equity. However, there is a case when the managers prefer to spend the company's money to enrich them and it will trigger the agency problem because they are not in line with the shareholders.

3. Risk Disclosure

In general, risk can be defined in many different ways. For Gibson (2003), risk is the chance of making a loss. There is famous sentence about risk, "high risk, high return". The meaning of the sentence is, investors will find that kind of risks if they want to get greater result and in exchange they will face greater risks in investment.

In CICA's MD&A, May 2004, stated on 360.2.2, risk is defined as the possibility that an event, action or circumstance will adversely affect an organization's ability to achieve its business objectives" and there is uncertainty about both the likelihood of occurrence and the consequences of a risk.

Table 1. Risk Disclosure Categories

Risk Types	Description
Financial risk	Interest rate
	Exchange rate
	Commodity
	Liquidity
	Credit
Operations risk	Customer satisfaction
	Product development
	Efficiency and performance
	Sourcing
	Stock obsolescence and shrinkage
	Product and service failure
	Environmental
	Health and safety
	Brand name erosion
Empowerment risk	Leadership and management
	Outsourcing
	Performance incentives
	Change readiness
	Communications
Information processing and technology risk	Integrity
	Access
	Availability
	Infrastructure
Integrity risk	Risk-management policy
	Management and employee fraud
	Illegal acts
	Reputation
Strategic risk	Environmental scan
	Industry
	Business portfolio
	Competitors
	Pricing
	Valuation
	Planning
	Life cycle
	Performance measurement
	Regulatory
	Sovereign and political

Source: Linsley and Shrives, 2005

According to Beretta and Bozzolan (2004), risk disclosure is defined as the communication of information concerning firms' strategies, characteristics, operations, and other external factors that have the potential to affect expected result.

In Lajili and Zéghal's research (2005), they gave a snapshot picture of the state of risks disclosures in corporate Canada and they emphasis of risk types is on non-financial risks such as business and operational risk, and environmental risks, as more valuable information about a firm's total risk exposure could be inferred from the non-financial side of operations.

In CICA's MD&A, May 2004, stated on 360.2 in Recommended Practice: A company should disclose its principal risks and describe related risk management systems to enable MD&A report readers to understand and evaluate the company's risks and its decisions regarding the management of such risk. Such disclosure should include:

a. the principal risks and uncertainties facing the company and its core businesses and segments, as appropriate;
b. the strategies and processes employed for managing these risks; and
c. the potential specific impact of these risks on results and capabilities, including capital resources and liquidity.

4. Factors that Influence Risk Disclosure

There are factors that influence risk disclosures of the companies, such as:

a. Company Size

Size of the company can be carried out in several methods namely through sales, employees, assets or value add features, but the main issue is how agency, transactions and the range of costs impact the profits (Zadeh and Eskandari, 2012). In their research, there are specific criteria for company size for their past literature research, such as measuring company size by total sales (TS), measuring company size by total assets (TA), measuring company size by market capitalization, measuring company size by total revenue (TR), measuring company size by sum of debt book value and equity market value and measuring company size by number of employees.

Lajili (2007) in Zadeh and Eskandari (2012) found that there is a positive effect between company size as measured by TS and the level of risk disclosure for samples used from Canada. Elzahar and Hussainey (2012) found the positive relation between company size as measured by TA and risk disclosure in UK Interim reports sample of 72 UK companies, but Hassan (2009) found that larger corporations do not have higher levels of corporate risk disclosure than smaller company which means the result is insignificant.

Based on Kajüter's research (2006) in Zadeh and Eskandari (2012), there was a positive relation between company size as measured by market capitalization and the level of risk disclosure for samples from Germany. Amran et al. (2009) found that there is positive effect between company size as measured by TR and the level of risk disclosure by sampled Malaysian companies.

Study of Deumes and Knechel (2008) in Zadeh and Eskandari (2012) found the size of companies based on the sum of debt book value and equity market value in order to find out the association between levels of risk disclosure and company size for samples from the Netherlands. Oliveira et al. (2011) found that company size based on the number of employees and the level of risk disclosure have positive relationship by sampled Portuguese companies in 2005. This study prefers to use measurement by total assets and use the natural log of total asset based on Hassan's research (2009) and Elzahar and Hussainey's research (2012).

b. Leverage

Companies with high levels of debt tend to be highly leveraged, more speculative and riskier (Oliveira et al., 2011). Debt is the proportion of credit extended by suppliers or a loan from a bank (Keown et al., 2005, pp. 37). Formulas to calculate company's leverage are debt to equity ratio, debt to asset ratio,

debt service coverage and long-term debt to total equity. Debt to equity ratio reveals the proportion of debt and equity a company is using to finance its business and also measures a company's borrowing capacity. The higher the ratio means the greater the proportion of debt and also the risk. This study prefers to use debt ratio as a proxy for leverage (Hassan, 2009; Ramezani, 2013; Amran et al., 2009; Oliveira et al., 2011).

c. Industry Type

In the past literature research, there was investigation about the relationship between disclosure levels and the industry type. Beretta and Bozzolan (2004) found that risk reporting differs among different industry sectors. Different industries would be influenced by different and unique constraints in their business environment; consequently, risk types and levels will differ among sectors according to complexity in value creation activities and prior risk reporting studies (Elzahar and Hussainey, 2012).

Roberts (1992) in Faisal et al. (2012) defined high profile industries as those with consumer visibility, a high level of political risk or concentrated intense competition. Hacston and Milne (1996) in Faisal et al. (2012) provided evidence that high profile industries tend to disclose more social and environmental information than low profile industries.

d. Profitability

Profitability ratio becomes one important part for measuring the company. Increasing profit is the best indicator that a company can pay dividends and that the share price will trend upward. Profitability can be measured by comparing profits with sales, assets or equity: net profit margin, return on assets, and return on equity. This study prefers to use ROE as a proxy for profitability (Mutawaa and Hewaidy, 2010).

e. Liquidity

Liquidity is the ability of a firm to pay its bills on time, and how quickly a firm converts its liquid assets (accounts receivables and inventories) into cash (Keown et al., 2005, pp. 41). Liquidity ratio can be measure by using current ratio, quick ratio/acid test ratio, cash ratio and inventory to net working ratio. This study prefers to use current ratio as a proxy for liquidity (Ramezani et al., 2013; Elzahar and Hussainey, 2012).

C. Frameworks

In this study, there are factors that influencing risk reporting, namely company size, type of industry, leverage, profitability and liquidity.

Based on the influence of those factors toward risk disclosure, the framework is:

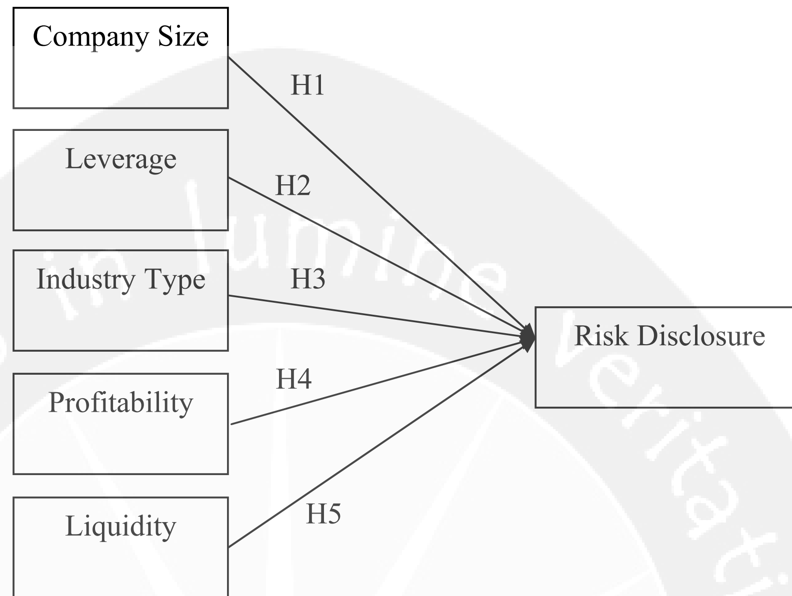

Figure 1. Framework of Risk Disclosure

Source: Anisa and Prastiwi (2012)

In Elzahar and Hussainey (2012); Kajüter (2006); Mohobbot (2005) in Zadeh and Eskandari (2012), they found a positive effect between firm size as measured by total assets and the level of risk disclosure. Based on Zadeh and Eskandari (2012), the most studies found a positive relationship between firm size and the level of risk disclosure and firm size can influence the risk disclosure level.

Deumes and Knechel (2008); Elshadidy et al. (2011); Hassan (2009); Marshall and Weetman (2007); Taylor et al. (2010) in Elzahar and Hussainey (2012) found a positive relationship between leverage ratio and

corporate risk disclosure. However Abraham and Cox (2007); Linsley and Shrives (2006); Rajab and Handley-Schachler (2009) in Elzahar and Hussainey (2012) found insignificant between two variables.

Cooke (1992) and Mangena and Pike (2005) in Elzahar and Hussainey (2012) found a relationship between industry type and corporate disclosure, however Wallace et al. (1994) and Aljifri and Hussainey (2007) in Elzahar and Hussainey (2012) found an insignificant relationship between industry type and disclosure. In Taures and Daljono's research (2011) industry types are classified in different ways, namely high profile industry and low profile industry.

Elshandidy (1999) in Elzahar and Hussainey (2012) examined the association between firm's profitability and level corporate disclosure and the result is significant while based on Vandemaele et al.'s research (2009) the result is insignificant.

Marshall and Weetman (2007) and Elshandidy et al. (2011) in Elzahar and Hussainey (2012) found the high-liquidity firms provide more risk information to send positive signals to investors. But, Wallace et al. (1994) and Mangena and Pike (2005) in Elzahar and Hussainey (2012) found no significant association between disclosure levels and liquidity.

D. Hypotheses

1. Company Size

Large companies tend to have high risks than small companies. Agency costs and the costs of capital expected return for the shareholders will be higher for larger company because generally larger companies attract more attention of shareholders and stakeholders than smaller company as stated in the literature review the problems of information asymmetry in Meijer (2011). Large companies are more vulnerable to financial risk because some assets are funded by loan, they also have high political risk because the government set up the regulation to prevent monopoly practices (Aljifri and Hussainey, 2007). In the past literature it was said that large companies disclose more information than small companies. Based on the explanation above, the following hypotheses are developed:

H_{a1}: Size of the company influences the level of risk disclosure.

2. Leverage

Based on agency theory, agency costs are higher in highly leveraged firms and managers tend to provide more risk management information in order to send a good signal to debt holders regarding the corporate ability to meet its obligations (Elzahar and Hussainey, 2012). As stated in Hassan (2009), corporation leverage as a proxy of risk, may affect the level of corporate risk disclosure. Having high leverage

ratio means the company has high debt as the financing and they disclose more information in the annual report. In Taures and Daljono's study (2011), by using debt to asset ratio, when debt to asset is high, it means the greater company's dependence level toward creditors and it is riskier in terms of difficulty on liabilities and interest payment. Hassan (2009) found that debt to equity ratio is positively and significantly linked to CRD level. However in Elzahar and Hussainey (2012), leverage had an insignificant relationship with the level of total corporate risk disclosure in interim reports. Based on the explanation above, the following hypotheses are developed:

H_{a2}: Company's leverage influences the level of risk disclosure.

3. Industry Type

Industry types are classified into low profile industry and high profile industry. The companies are classified into high profile industry are airlines, agriculture, cigarette and tobacco, food and beverage, media and communication (electricity), engineering, health, transportation and tourism, forest and paper, automobile, airlines, metal, oil utilities, chemicals, extractive and mining, energy and fuel, and liquor; and the low profile industries are financial and banking, retailer, household products, consumer goods, construction and property, service, food, health and personal products, hotel, building, electrical, textiles and apparel, retailers, medical supplies (Hackston and Milne, 1996; Roberts, 1992; Newson and Deegan, 2002; Murtanto, 2004). Companies that operate in different industries are expected to

experience different kinds of risk (Amran et al., 2009). On the other hand, as stated in Lopes and Rodrigues (2007) in Hassan (2009), corporations operating in the same industry are more likely to exhibit the same level of risk disclosure in order to avoid negative appreciation by the market. Based on the explanation above, the following hypotheses are developed:

H_{a3}: Industry type (high or low industry) influences the level of risk disclosure.

4. Profitability

Profitability is an indicator of company's improvement because the higher the profit means better performance. Ahmed and Cortis (1999) in Elzahar and Hussainey (2012) found the previous study results provide mixed evidence on the association between firm's profitability and level of corporate disclosure. Profitability was found insignificantly with risk disclosure, because the company more concerned with high profitability and few information disclosure (Anisa and Prastiwi, 2012; Elzahar and Hussainey, 2012; Vandemele et al., 2009). But, Elshandidy et al. (2011) in Elzahar and Hussainey (2012) reported positive association between profitability and risk disclosure. Managers tend to disclose more risk information to the annual reports to provide the performance to the stakeholders. Based on the explanation above, the following hypotheses are developed:

H_{a4}: Company's profitability influences the level of risk disclosure.

5. Liquidity

Liquidity of a company is a condition when a company is able to fulfill all of the short-term liabilities or obligations. According to signaling theory, companies' managers will disclose more information if their liquidity ratios are high, to distinguish their skills in managing liquidity risks comparing with other managers in companies with lower liquidity ratios (Elzahar and Hussainey, 2012). Based on the explanation above, the following hypotheses are developed:

H_{a5}: Liquidity influences the level of risk disclosure.