

INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT

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RISK DISCLOSURE BY SELECT INDIAN BANKS WITH REFERENCE TO IFRS 7 / IND AS-32: A STUDY

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ABSTRACT

Although banks have always been risk-taking entities, the recent financial crisis resulted in an increased attention on the risks of banks and their financial instruments. This research therefore examines the disclosures of market, credit, and liquidity risks of a sample of Indian banks in their 2012-2013 annual reports. By constructing two disclosure index frameworks and applying these to the annual reports the quantity and quality of the risk disclosures are examined. Since the outcomes of the empirical research show that there are differences in disclosures scores between banks, several hypotheses are developed based on among others the political cost theory and the fact that new regulation on risk disclosures (IFRS 7) has been introduced in 2007 & Basel II Pillar III as well. The relationships that are examined are the following: (1) the quantity and quality of disclosures, (2) disclosures and bank size, (3) disclosures and bank profitability. The present study contributes to the accounting literature for several reasons, amongst others because it focuses on risk disclosures in a sector that has only been examined by a few other researchers before. Next to that, it provides a sound basis for future research like capital market research, event studies, and behavioral studies in relation to risk disclosures.

KEYWORDS

Financial Crisis, AS-32, IFRS-7, Risk Disclosure.

1.0. INTRODUCTION

Banks are especially unpopular in two circumstances: first, when they are very profitable; and second, when they are very unprofitable¹

Sir Davies, LSE

In 2007, and even more in 2008, the world got confronted with an international financial crisis, also called the credit crisis. Worldwide banks had invested billions of Euros in financial instruments like sub-prime related collateralized debt obligations (CDO's), but due to increasing interest rates, decreasing values of houses and the consequences of that for the repayment of mortgages in the United States, the value of these and other financial instruments decrease significantly. Since International Financial Reporting Standards prescribe to impair on these financial instruments through the profit and loss account when the value declines significantly, banks had to report billions of Euros of losses. One of the industries that is hit hard by the crisis is the Indian banking industry, that even needed support from the government to survive. Although Sir Davies states that banks become unpopular when they are very unprofitable. Since the existence of banks these are known to be major risk taking and risk management entities. Hypovereinsbank (2009, 40) even describes in their annual report that 'as a rule it is not possible to earn income in the banking business without incurring risk'. According to Linsley and Shrivs (2005, 205) they are therefore "expected to release relevant risk-related information to the marketplace, as part of good corporate governance". The annual report is for many years used to communicate firm performance with shareholders and stakeholders and includes, in general, both mandatory and voluntary disclosures. Although regulation is meant to protect the stakeholders, some argue however that this will only lead to an oversupply of accounting information (Deegan and Unerman, 2006, 49).

1.1. WHY ASSESS BANK DISCLOSURE PRACTICES?

Enhanced disclosure leads to better transparency and stronger market discipline in the banking sector. The third pillar of Basel II and Basel Core Principles No.21 explicitly asks for better disclosures by banks to allow the market to have a better picture of the overall risk position of the banks and to allow the counterparties of the banks price and deal appropriately. More disclosures should reduce information asymmetry between those with privileged information and outside small investors, and facilitate more efficient monitoring because sufficient information is necessary for market participants to exert effective disciplinary roles¹. According to McKinsey's "Global Investor and Emerging Market Policymaker Opinion Surveys on Corporate Governance", "accounting disclosure" is listed as the number one most important factor considered by 71% of investors surveyed, and "enhanced disclosure" is named as number one key progress area by 44% of policymakers.

Accounting disclosure is raised to a particularly high level of importance for banking organizations compared to firms in other industries, for several reasons. Accounting reports are almost the sole source of information for bank investors and other stakeholders. Banks own few physical and visible assets and investors can get a sense of a bank's performance and asset quality only from accounting numbers. Earnings numbers alone are not adequate for assessing the valuation of banks, the main business of which is to take risks and to provide liquidity (and thus earnings can be inflated through doing more of them). Thus profitability does not give investors the whole picture of the bank's financial situation, until risk profile of the bank is holistically disclosed. Finally, aggregate accounting numbers (e.g., total profits, total loans) without certain level of breakdown is less informative for banks than it is for industrial firms, because the most important information lies in the details of the sources of income and expenses, or quality of assets. Investors need this information to make judgments on which incomes are sustainable and which expenses are recurring. *Transparency and disclosure is critical to banking sector stability.* Enhanced bank disclosures have been showed to be able to make banking crisis less likely to happen (Tadesse [2005], Hoggarth, Jackson, and Nier [2003]), because in high disclosure regime banks are less likely to take excessive risks (Nier and Baumann [2006]), and when they happen the losses less costly (Rosengren [2001]). The reason is that worse-run banks will see their funding base shrank as a result of market discipline, and thus situations would not have deteriorated to a disaster-level in the first place. The key for market discipline however is information disclosure. Cordella and Yeyati (1998) and Boot and Schmetis (2000) both show that, ex-ante, managers will chose lower risk when the risk profile is observable to outsiders; and ex-post, when a banking crisis does occurs, Hoggarth et al. (2003) argue that disclosures reduce the likelihood of runs on fundamental sound banks.

Because of the systematic importance of banks and the safety net extended to them paid by taxpayers, enhanced disclosures are not only necessary and relevant for publicly traded banks, but also for privately-held and state-owned banks. As a matter of fact, disclosure has already become one of the key principles highlighted in the "OECD guidelines of governance of state-owned enterprises". The failure of banks always hurts large number of stakeholders such as depositors, and brings about political and reputation risks. Even when banks are fully insured or owned by the government, bank disclosures are still useful for tax payers, who ultimately shoulder the costs of bail-outs, in monitoring and disciplining the banks. Transparency & disclosure is one of the core components in many Bank/Fund operations in financial sector, e.g., FSAP, ROSC, and IFC's Corporate Governance.

Currently, data needed for assessment purpose are collected on an *ad hoc* basis prior to each individual FSAP or ROSC missions. The establishment of a quantitative benchmarking system with timely data on disclosure practices around the globe is long overdue and if completed will greatly facilitate cross-country

¹ As proposed by Andrew Crocket (BIS), four pre-conditions have to be met in order for market discipline to work effectively. They are: (1) Market participants need to have sufficient information to reach informed judgments. (2) They need to have the ability to process it correctly. (3) They need to have the right incentives. (4) They need to have the right mechanisms to exercise discipline.

comparisons and the use of peer pressures. Furthermore, the disclosure items examined in this project are closely linked to what are already included in IMF's Financial Soundness Indicators framework (the core and the encouraged set), which creates compatibility with IMF-led operations, while at the same time seeks to provide more disaggregated level information in the assessment of financial stability in member countries.

A simplified and standardized checklist of core disclosure items needs to be developed for low and mid-income countries. There already are many initiatives made by not only international standard-setting bodies such as the IASB and Basel committee, but also national regulators to standardize financial reporting of banks, to make information disclosure more comparable across banks, through fixed formats of presentation. In BCBS report "Enhancing bank transparency", it is recommended that "one area in which supervisors are well suited to take on a productive role is in enhancing comparability by promoting the use of supervisory definitions and reporting classifications in public disclosure." The new IFRS 7 has replaced IAS 30 and asks for more detailed disclosure from financial institutions. Comprehensive as the new rule certainly is, the long laundry list prescribed is too remote for less complex banks in mid- and low-income developing countries. A smaller checklist of core items thus is needed, which has to be concise, easy to understand, easy to benchmark, and applicable to economies at all stages of development.

2.0. BRIEF REVIEW OF THE AVAILABLE LITERATURE

A large number of studies have been conducted the world over covering different aspects of corporate disclosure through annual reports. A few of these studies have been discussed below in order to understand the nature, methodology and findings that will help to compare and find the gap with the present study.

Cerf (1961) empirically investigated the extent of disclosure of 527 companies in USA and associations between extent of disclosure and four corporate attributes viz., size, ownership pattern, profitability and method of trading shares.

Singhvi and Desai (1971) studied the association between disclosure of information and six corporate characteristics, namely asset size, no. of stockholders, listing status, type of CPA firms, rate of return and earnings margin of 100 listed and 55 unlisted US companies for the year 1965-66.

Barret (1976) examined the extent of overall disclosure and the degree of comprehensiveness of financial statements in the annual reports of 103 large publicly held companies operating in seven countries (fifteen each from the USA, the UK, Japan, France, Germany and Sweden and thirteen companies from the Netherlands) for the years 1963 to 1972.

Shankar (1972) analyzed the adequacy of corporate reporting practices in the annual reports of Indian companies as compared to foreign companies, such as, USA, UK, Germany and Japan.

Singh and Gupta (1977) examined the relationship between the level of disclosure and seven organizational correlates of 28 Indian companies (28 private and 6 public sector companies) by using weighted disclosure index.

Singh and Bhargava (1978) analyzed relationship between the extent of disclosure and organization pattern and nature of industry of 40 public sector enterprises in India with the help of an index consisting of 35 items.

Lal (1985) examined the extent of disclosure in annual reports of 180 manufacturing companies in the private sector in India for the years 1965 and 1975 by preparing a disclosure index consisting of 50 major items (104 items in all with all possible sub-items).

The Research Committee of ICAI (1985) surveyed the annual reports of 87 private sector companies and 25 public sector companies to study their reporting practices.

Chander (1992) measured the extent of disclosure by applying the 'index of disclosure' to the annual reports of top 50 companies from public and private sectors for the years 1980-81 to 1984-85.

Vasal (1992) examined the quality of corporate financial reporting of 129 Central Public Sector Companies (CSPCs) in India for a period of four years from 1988 to 1991. He analyzed the corporate reporting under three major heads – extended corporate reporting, extended financial reporting and extended social reporting. Applying an index of disclosure consisting of 65 non-statutory items, he measured the variability of disclosure – both weighted and unweighted scores of 129 CSPCs. In addition to disclosure index, six corporate attributes (i.e. size, age, rate of return, review of accounts by CAG, nature of industry and participation in best presented account competition) were also examined. He used univariate, bivariate and multivariate statistical techniques.

Rathinam (1996) has made a comprehensive study about disclosure practices of 160 Indian companies (114 private sector and 46 public sector) using an index of disclosure consisting of 114 items. He also examined the relationship between various corporate attributes and disclosure, and analysed disclosure practices of companies regarding certain contemporary issues in financial reporting like Social Responsibility Accounting, Human Resource Accounting, Value Added Statement etc.

Ubha (2001) examined the annual reports of 50 selected companies for the period 1989-90 to 1993-94 to find out the general disclosure trends and practices prevalent in the corporate sector in India by using an index of disclosure.

Paul and Pai (2001) examined corporate environmental reporting in the annual reports of 23 companies for the sample period of 13 years – 1986-87 to 1998-99.

Banerjee (2005) examined environmental accounting and reporting practices of 60 companies in India for the financial year 2002-03.

Nangia (2005) examined the disclosure practices of MNCs operating in India as against domestic companies by taking a sample of ten MNCs and ten domestic companies for a period of ten years from 1992 to 2001. She studied the association between the extent of disclosure and certain company characteristics like size, profitability and type of industry.

Mahajan and Chander (2007) studied the disclosure practices of 50 software firms in India for the year 2004-05 using a disclosure index of 90 items. They also examined the relationship between extent of disclosure and certain corporate characteristics (age, listing status, shareholding pattern, leverage, size, profitability, audit firm size, residential status) with the help of multiple regression analysis.

3.0. FINDING OUT THE ULTIMATE RESEARCH VACUUM

A minute review of literature reveals that very few studies are industry specific and enormous literature is available on the analysis of different aspects of disclosure of the non-financial companies worldwide. Very scanty literature is available on examining the different aspects disclosure by banks, insurance companies and financial institutions. Therefore, the need to carry out this study was felt. The present study is an attempt to analyze the disclosure practices of the Indian banking companies, specifically the risk disclosure practices. Also, an attempt will be made to examine the association between the extent of disclosure and various company-specific characteristics with the help of a statistical model.

4.0. OBJECTIVES OF THE STUDY

Since there are only a few empirical studies on risk disclosures by banks and the interest in risk disclosures has strongly increased due to the financial crisis, it is interesting to examine this topic. Both a literature study and empirical research of risk disclosures in the Indian banking industry will be conducted in order to increase the understanding of why risk disclosures are important and what the developments in this area are.

One of the objectives of this study is to develop new disclosure frameworks that can measure the quantity and quality of risk disclosures in the banking sector and that can overcome certain limitations of previous research. Although quantity is also assumed to be a good proxy for the quality of information in other studies, which is logical when the disclosed information is relevant for the user, the quality framework in this project also takes into account the other qualitative characteristics of the IASB framework: understandability, comparability, and reliability. The quantity framework is based on IFRS 7 and measures quantity by counting the number of pre specified items disclosed. In order to distinguish between quantity and quality, these separate frameworks will therefore be called the quantity framework and quality framework throughout the rest of this research.

The main objective of this project is to examine the developments of risk disclosures in annual reports over time and the differences between banks. Therefore the frameworks will be applied to a sample of 19 Indian banks, resulting in disclosure scores that can be analyzed and tested for relationships with bank size, profitability, and time. Next to that, more insight will be provided into the relationship between the quantity and quality of disclosures.

5.0. RESEARCH QUESTIONS

In this project the problem is defined by the following main project question:

"How can differences in the quantity and quality of financial instrument risk disclosures in the annual reports of German banks be measured and explained?"

Before conducting own empirical work it is important to examine the theoretical background first. To support the main project question, the following sub questions are therefore drawn up:

1. *What is risk and what are risk disclosures?*
2. *What are financial instruments and their risks?*
3. *What is the quantity disclosure score by sample Indian banks?*
4. *What is the quality disclosure score by sample Indian banks?*
5. *Is there any significant correlation exists between quantity and quality disclosure score by sample Indian banks?*
6. *Can the quantity disclosure score of sample Indian banks can be explained by variables of bank size and profitability of banks?*
7. *Can the quality disclosure score of sample Indian banks can be explained by variables of bank size & profitability of banks?*

6.0. RESEARCH DESIGN

This project is divided in three major parts.

The first part is descriptive that consists of a literature study in which not only the background of risk disclosures is discussed, but also the institutional setting of India. In order to understand how studies on risk reporting can be conducted and what the limitations of the methodologies are, the concept of content analysis will be explained before the second and third part of the research will be described.

The second part of this research consists of the construction of disclosure index frameworks that will make it able to measure the quantity and quality of risk disclosures. Consequently these will be applied to the annual reports of 2012-2013 of 19 Indian banks that are included in the sample.

Differences in disclosure scores are expected and in the third part of this research. These will be tried to explain by testing the relationships between disclosure scores and other variables. Pearson correlation coefficients and a paired sample t-test will be calculated in statistical software and conclusions will be drawn based on these results.

7.0. BACKGROUND OF RISK AND RISK DISCLOSURES

Regulation regarding financial reporting and disclosures has an impact on every firm. Financial reports and disclosures are however "potentially important means for management to communicate firm performance and governance to outside investors" (Healy and Palepu, 2001, 405). These disclosures can give information on several topics, including earnings forecasts, corporate social responsibility, segments and risks. This research focuses on risk reporting by banks, with the disclosures on this topic becoming less voluntarily in the past few years.

7.1. CONCEPT OF RISK

In the past, and more specifically the pre-modern era, people considered risk to be something negative because it was at that time associated with the occurrence of natural phenomena (Linsley and Shrivs, 2006, 388; Lupton, 1999). Serious studies of risk started to be performed in the Renaissance by Pascal, Fermat and others who based this on advances in algebra and calculus, and in the 17th and 18th century modern techniques for quantifying risk were developed (Bernstein, 1996). In economics the concept of risk and uncertainty was introduced by Frank H. Knight (1921), who referred to risk as a 'measurable uncertainty' and considered uncertainty as non-quantitative.

Nowadays, in the modern era, there are according to Dobler (2008, 187) two views on risk: an uncertainty-based and a target-based view. The first "defines risk as randomness of uncertainty of future outcomes that can be expressed numerically by a distribution of outcomes" (Dobler, 2008) and is based on the concept of risk as introduced by Knight (1921). The second view, the target-based view, "defines risk as the potential deviation from a benchmark or target outcome" (Dobler, 2008, 187; Borch, 1968).

Risk is driven by internal and external factors, and is according to the ICAEW inherent in business. Both the ASB and ICAEW view risk as the "uncertainty as to the amount of benefits" and "the term includes both potential for gain and exposure to loss" (ICAEW, 1998, 5). In the case of the upside risk profile, "all the results that have any likelihood of happening give a positive net cash flow" (ICAEW 1998, 7), in the case of the down-side risk profile there will be a negative net cash flow.

According to Beretta and Bozzolan (2004, 269) risk disclosures can as a consequence of the above definition be defined as "the communication of factors that have the potential to affect expected results". The definition of Linsley and Shrivs (2006, 389) is however more extensive and includes the "opportunity, prospect, hazard, harm, and threat of exposure".

In view of the fact that banks are known to be major risk taking and risk management entities that make their money by taking risks, the broad and more general definition of risk will be used in this research. This includes past, future, good, neutral and bad news, and is in accordance with the modern view of risk as defined by the ICAEW (1998). Given that this project mainly focuses on the risks of financial instruments.

7.2. RISKS OF FINANCIAL INSTRUMENTS

In recent years, the techniques used by entities for measuring and managing exposure to risk arise from financial instruments have evolved and new risk management concepts and approaches have gained acceptance. The users of the financial statements need information about an entity's exposure to risk and how these risks are managed. Such information can influence a user's assessment of financial position and financial performance of an entity or of the amount, timing and uncertainty of future cash flow. Greater transparency regarding those risks allows users to make more informed judgments about risk and return. Thus risk disclosure means disclosing and informing the relevant risk and risk factors to the users of financial statements for the present and future period².

Risk disclosure can be beneficial for several reasons. It mitigates information asymmetry between management and external shareholders and can have positive effects on the trust and confidence stakeholders have in the firm's management. It may decrease the firm's perceived risk because an open disclosure strategy supposedly results in a better assessment of the firm's future performance. This, in turn, can lead to a decline in the firm's cost of capital (Linsley and Shrivs, 2006a; Abraham and Cox, 2007; ICAEW, 1999a) and to a reduced possibility of financial failure (Beretta and Bozzolan, 2004; Solomon *et al.*, 2000)³.

Banks in India are required to make risk disclosures under Basel II Accord from 2008-2009 in few cases 2009-2010 for all banks. On the similar line, recognizing the importance and relevance of risk related disclosure IASB issued IFRS 7 – Financial Instruments Disclosure which was made applicable in many countries of the world since year 2007. However Indian AS 32 same as IFRS 7 has been issued by Indian Accounting Standard Board, which is made compulsory from 1-4-2011 for the most of the entities in India.

7.3. INDIAN ACCOUNTING STANDARD 32 - FINANCIAL INSTRUMENTS: DISCLOSURES

This AS issued by the Council of the ICAI, came into effect in respect of accounting periods commencing on or after 1-4-2009 and was recommendatory in nature for an initial period of two years. This Accounting Standard is mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity. The disclosures focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, liquidity risk and market risk⁴. This Accounting Standard is based on

² Sharma M, "Basel II Tectonic Shift", *Treasury Management*, The ICAI University Press, September 2008, p. 22.

³ Vandemaele S. 'Management Risk Reporting Practices and their Determinants A study of Belgian listed firms.' 2009. p.1, uhdspace.uhasselt.be/dspace/bitsstream/1942/.../2/CorporateriskB.pdf

⁴ Rawat D. S., 'Students Guide To Accounting Standards,' Taxmann Publishing Pvt. Ltd., 21st Edition, 2012, p. 554

International Financial Reporting Standard (IFRS) 7, Financial Instruments: Disclosures issued by the International Accounting Standards Board (IASB). There is no material difference between Indian AS 32 and IFRS 7.

7.4. BASEL II PILLAR 3 DISCLOSURES

Over and above Indian AS 32, Indian banks are required to make risk disclosures as per Basel II Pillar 3 disclosures. The objective for these disclosures is to have better disclosure, market discipline and safe and sound banking system. Pillar 3 primarily aims at disclosure of bank's risk profile and capital adequacy. Basel II guidelines are specified by the RBI also include the following 10 schedules in the financial statements. The requirements as per Indian AS 32 for financial instruments are subsets of Basel II pillar 3 disclosures (namely DF 4, DF 5, DF 6, DF 8 and DF 10) as under:

DF 1 – Scope of application	DF 2 – Capital structure
DF 3 – Capital adequacy	DF 4 – Credit risk – general disclosures for all banks
DF 5 – Credit risk – disclosure for portfolios subject to the standardized approach.	DF 6 – Credit risk mitigation – disclosures for standardized approaches
DF 7 – Securitization – disclosure for standard approaches	DF 8 – Market risk in trading book
DF 9 – Operational risk	DF 10 – Interest rate risk in the banking book

7.5. RATIONALE BEHIND RISK REPORTING

Although regulators and standard setters mainly focus on the information needs of users of financial statements and therefore claim that risk disclosures are necessary, the companies itself can also benefit from it. First the rationale behind risk reporting from the information asymmetry and agency problem perspective will be explained. Next to that the information risk perspective, the political cost theory and the signaling perspective will be shortly discussed. According to Healy and Palepu (2001, 406) information asymmetry and the agency problem cause the demand by outside investors for disclosures to be made by management. Information asymmetry, also described by Akerlof (1970) as the 'lemons problem', means that these investors and managers do not have the same extent of information, with the latter usually having more and better information. In the context of this research, the bank manager will have more information about risks that might affect future results than the share- or stakeholder. Consequently, disclosing more about these risks will result in a reduction of the information asymmetry. From the point of view of the stakeholder this is favorable since disclosed information can be taken into account in the decision making process. The agent will however be reluctant to remove some of the information asymmetry for the reasons that will be discussed later on in this section. The agency problem arises due to the difference in interest between an agent and a principal, with the first being the manager and the latter being the shareholder (Jensen and Meckling, 1976; Fama, 1980). The problem here is that the agent has the incentive to act in his own interest, which is not always in the interest of the shareholder. Healy and Palepu (2001, 410) describe several ways to reduce the agency problem, including compensation contracts, corporate governance, information intermediaries and disclosures. Irrespective of the fact that disclosures in general might reduce the information asymmetry and agency problem, they might also result in reduced costs of capital. According to Helbok and Wagner (2006a, 9), from an information risk perspective, "investors demand of returns depends on the level of information provided to them through disclosures". Several empirical studies have tried to confirm the connection between risk disclosures and the cost of capital and found support that the cost of equity capital declines when the amount of disclosures increase (Botosan, 1997; Healy and Palepu, 2001; Hutton, 2004; Botosan, 2006). The ICAEW and IASB 26 share this view and also state that risk reporting will help companies in managing their risk and to improve their risk management. Last, but not least they also believe that information on risks will "improve accountability for stewardship, investor protection and the usefulness of financial reporting" (ICAEW, 2002, 7).

By disclosing more information about risks, shareholders are better able to understand the company's future economic performances and its market value (Schrand and Elliot, 1998; Linsley and Shives, 2006; Abraham and Cox, 2007; Dobler, 2008). According to the Modern Portfolio Theory of Markowitz, this information is used in decision making and gives the opportunity to maximize shareholders' value (Markowitz, 1991; Solomon et al., 2000, Abraham and Cox, 2007). There are however according to Linsley and Shives (2000) also two other perspectives on why companies, financial and non financial, would disclose risk information: the political cost perspective and the signaling perspective. According to Helbok and Wagner (2006a, 11) and based on the Political Cost Theory by Watts and Zimmerman banks will disclose more information in order to attract less attention from supervisors like the Authority of Financial Markets (AFM) or the central banks. Next to that, the signaling perspective suggests that banks want to distinguish themselves from each other and that especially banks that are performing well will be early adopters of risk disclosures (Helbok and Wagner, 2006a, 11). Others however suggest that the rest of the industry will imitate these early adopters (DiMaggio and Powell, 1983) and that the behavior of the dominant bank might shape the disclosures within an industry (Cooke, 1992).

Next to the above mentioned perspectives Dobler (2008, 186) "considers risk reporting to be an endogenous feature and, thus, are motivated from risk management and game setting perspectives". Incentives for risk reporting are important, even when there is regulation. It is however not always in the advantage of the company or manager to disclose certain information. Linsley et al. (2006) state that there are two reasons why managers are reluctant to do this. The first reason is that there is a 'problem of proprietary information', because information might be commercially sensitive and can give competitors an advantage. Second, there is the issue of forward-looking information. Although Solomon and Solomon (2004) examined that forward looking is found to be more useful in the decision making of investors and the ICAEW states this as well, forward-looking information is "unreliable and could leave directors open to potential claims from investors who have acted upon this information" (Linsley et al., 2006, 269). According to Dobler (2008) and its analytic models this threat of litigation is also one of the reasons why managers might not report on risks. Fuller and Jensen (2002) on the opposite however state that being clear about risks could prevent reputation damage.

Whether mandatory risk disclosures are better than voluntary risk disclosures can be questioned. According to Hutton (2004) and Solomon et al. (2000) voluntary risk disclosures are preferred, because relevant information cannot be standardized. Despite this, regulators and accounting standards boards continued to examine this topic and by now laws and regulations about risk reporting exist in certain parts of the world and for certain companies (for instance banks).

7.6. PREVIOUSLY USED MODEL

An approach that is previously used in risk disclosure studies makes use of a model created by Arthur Anderson (also known as the Deloitte model, Groenland et al. 2006) and is published by the ICAEW in 1998. According to Linsley and Shives (2006), Kajüter (2001) was the first to use this model. Other studies by Linsley and Shives (2006) and Linsley et al. (2006) consequently make use of this model in their specific risk disclosure studies.

7.7. FINANCIAL INSTRUMENTS DISCLOSURES - IFRS 7

To improve the disclosure framework of risks arising from financial instruments and provide financial statement users with greater transparency about an entity's exposure to risks, the new disclosure requirement in IFRS 7 has been adopted and applies to accounting periods beginning on or after 1 January 2007. IFRS 7 sets out guidelines of the application requirement and allows users of the financial statements to make more informed judgments about risk and return. It requires the disclosure of risk exposures in both qualitative and quantitative way. In this way, those entities can communicate to the market on its risk management strategies more effectively. Such new disclosure requirement applies not only to financial institutions, but also to all entities including those that do not have comprehensive financial instruments.

The new disclosure requirement in IFRS 7 / HKFRS 7 has been adopted and applies to accounting periods beginning on or after 1 January 2007. With the adoption of IFRS 7, the framework of quantitative disclosures of risk has been expanded. Some common risks include Credit Risk that arises from the uncertainty in a counterparty's ability to meet its obligations, Liquidity Risk which is a financial risk resulting from uncertain liquidity, Interest Rate Risk which leads to the change in the investment's value of an instrument as a result of the change in the absolute level of interest rates, Market Risk which arises from the uncertain market value of a portfolio and Other Price Risk which arises from the change of value in financial instruments affected by changes in commodity prices or equity prices.

IFRS 7 sets out guidelines of the application requirement and allows users of the financial statements to make more informed judgments about risk and return. It requires the disclosure of risk exposures in both qualitative and quantitative way. In this way, those entities can communicate to the market on its risk

management strategies more effectively. Such new disclosure requirement applies not only to financial institutions, but also to all entities including those that do not have comprehensive financial instruments.

8.0. FRAMEWORK OF THE STUDY

The study on risk disclosure of financial instruments includes market risk, credit risk and liquidity risk. Prior research on risk disclosure used content analysis (e.g. Linsley and Shrivs (2006), Amran et al (2009) while others (e.g. Hossain (2008), Oorschot (2009)) developed disclosure index to measure the extent of disclosure. As the objective of the study is to know the extent of risk disclosure and relationship of variables like profitability and bank size, disclosure index method was considered more appropriate. As discussed earlier, two types of information namely quantity and quality of risk disclosure is required by IFRS 7/ AS 32. The disclosure index developed by Oorschot⁵ (2009) is used for the study. The quantity disclosure index consists of 59 items and quality disclosure index consists of 13 items (Table 1 and 2). If an item is present in the annual report one point is awarded to the item, if the item is not present no points is given for the item.

8.1. HYPOTHESES

In order to find possible explanations for the differences in disclosure scores a limited amount of hypotheses is developed that will test the relationship between quantity and quality scores, with certain firm-specific characteristics, and with time. The hypotheses and the logical basis for the development of it are explained below. Due to the limited amount of research on this specific topic these hypotheses are mostly based on general risk disclosure studies.

8.2. QUANTITY VERSUS QUALITY

An important contribution to the already existing accounting literature on disclosures can be provided by examining the relationship between the quantity and quality of risk disclosures. As explained in previous sections, certain researchers assume that quantity is a good proxy for the quality as well, but no clear explanation for this has been given. Other researchers state that this relationship cannot just be assumed and a study by Beretta and Bozzolan (2008) on forward looking information shows as well that the quality of disclosures is not related to the quantity of disclosures.

In this study quantity is measured by the quantity framework, and quality by the quality framework. To a certain extent the quantity framework measures quality as well, by including items related to relevance, but the quality framework also takes into account comparability, understandability and reliability of information. In order to examine what the relationship between the quantity and quality of risk disclosures in the banking sector is the hypothesis below is drawn up. There is however no clear theoretical background for the expectation that banks that disclose a lot of information do not automatically also provide information of better quality.

8.3. RISK DISCLOSURES AND BANK SIZE

The second set of hypotheses to be tested focuses on the relationship between risk disclosures and the size of banks. In general, larger companies attract more attention of share- and stakeholders than smaller companies. According to the Political Cost Theory this might lead to higher political cost and one way of reducing these costs is to disclose more information, for instance about risks. Also the problems of information asymmetry, agency costs and higher demand of returns for shareholders will be higher for larger companies. In accordance with Diamond and Verrechia (1991, 1325) larger companies and banks are therefore expected to disclose more risk information.

Previous studies have found a positive relationship between the level of risk disclosures and the size of non-financial companies in inter alia the UK, Italy and Malaysia. Linsley et al., (2006) however also found this positive relationship for UK and Canadian banks when examining a total amount of 18 annual reports in 2002. The rationale for this relationship would be that stakeholders "have an expectation that larger banks should be providing more disclosures or have more varied information needs and consequently larger banks may be responding to this expectation or need" (274). On the other hand, institutional isomorphism, as described by DiMaggio and Powell (1983), suggests that financial firms imitate each other in their risk disclosures (Linsley et al., 2006, 279) and also according to Cooke (1992) the behavior of a dominant company may shape the disclosures within an industry.

Based on the political cost theory one can expect to find a positive relationship between bank size and the quantity of disclosures. However, only in the years before the disclosures of IFRS 7 became mandatory (2005-2006). In the years 2007-2008 no significant relationship is expected since the disclosure requirements are in this period equal for all banks.

The relationships between the quantity of disclosures and bank size will be examined by testing the following hypotheses:

H2a: There is no significant positive relationship between the quantity of risk disclosures in the annual reports of Indian banks and bank size in the period 2012-2013.

H2b: There is a significant positive relationship between the quantity of risk disclosures in the annual reports of Indian banks and bank size in the period 2012-2013.

For examining the relationship between the quality of risk disclosures and bank size the Hypotheses below are drawn up.

It is expected that larger banks produce qualitative better annual reports since they have more political exposure and in general more stakeholders that make use of the annual report.

H2c: There is a significant positive relationship between the quality of risk disclosures in the annual reports of Indian banks and bank size in the period 2012-2013.

H2d: There is a significant positive relationship between the quantity of risk disclosures in the annual reports of Indian banks and bank size in the period 2012-2013.

8.4. RISK DISCLOSURES AND PROFITABILITY

The fact that a bank might be larger, for instance based on total assets, does not necessarily have to mean that a bank is also more profitable. The question for this research is therefore what the relationship between risk disclosures and bank profitability is. According to Helbok and Wagner (2006a, 11) banks that are more profitable will be early adopters of risk disclosures since they want to distinguish themselves from the other, less profitable banks. Next to that, the political cost theory also gives rise to the expectation that more profitable banks will disclose more risk information in order to reduce the political costs. Whether risk disclosures lead to higher profitability or higher profitability leads to more risk and better risk disclosures is however not the relationship that will be examined in this research.

Previous empirical research on operational risk disclosures by Helbok and Wagner (2006b) shows a negative relationship between operational risk disclosures by banks and their profitability level as measured by the net profit divided by total assets. In contrast with their expectation, Linsley et al. (2006) do not find a significant positive relationship between the quantity of risk disclosures by banks and the relative profitability. In general mixed results are found, but in accordance with the theory and expectation that by risk disclosures banks can show the users of the annual report that they manage their risks well, the following hypothesis is drawn up for the years 2012-13 :

H3a: There is no significant positive relationship between the quantities of risk disclosures in the annual reports of Indian banks and the relative profitability of the banks in the period 2012-13.

Since the disclosure requirements became equal for every bank in the years 2007-2008 differences that are related to the profitability of a bank are not expected and therefore the following hypothesis is drawn up for the years 2012-2013.

H3b: There is a significant positive relationship between the quantity of risk disclosures in the annual reports of Indian banks and the relative profitability of the banks in the period 2012-2013.

Concerning the relationship between the quality of risk disclosures and bank profitability the following hypotheses are drawn up, for the same reasons as mentioned for hypotheses 2c and 2d.

⁵ Oorschot L. Van, "Risk Reporting: An Analysis of German Banking Industry", Master Thesis, Erasmus university Rotterdam, July 2, 2009.

H3c: There is no significant positive relationship between the quality of risk disclosures in the annual reports of Indian banks and the relative profitability of the banks in the period 2012-2013.

H3d: There is a significant positive relationship between the quality of risk disclosures in the annual report of Indian banks and the relative profitability of the banks in the period 2012-2013.

9.0. MEASUREMENT OF VARIABLES

9.1. BANK SIZE

In order to calculate the correlation between bank size and disclosure scores, the measurement of the variable bank size has to be determined. Previous studies on disclosures by non-financial companies, for example by Botosan (1997), consider the market value of equity at year end to be a good measure of company size. However, other measurements as turnover, total assets, and the number of employees can also be used to measure the size of a company. Hackston and Milne (1996, 87) state that "no theoretical reasons exist for a particular measure of size", and therefore they measure size in their study by market capitalization, sales and total assets. Whether these measures are also appropriate for measuring bank size is the question. According to Linsley et al. (2006, 275) turnover cannot be considered to be an appropriate measure since banks "do not derive profit from sales in the same way that the profits of say, a manufacturing company derive from sales".

Total assets are used in the study by Linsley et al. (2006), but since not all the banks included in the sample of this research are stock-listed market capitalization cannot be used. Therefore bank size will in this work be measured by total assets, and in order to prevent heteroscedasticity by taking the natural logarithm of total assets.

9.2. PROFITABILITY

The variable profitability can be measured in several ways, especially since both absolute and relative profitability can be distinguished. In the case of relative profitability financial ratios are calculated, which make it easier to compare performances between companies and over time. In the case of bank performances the Return on (Average) Total Assets (ROA) and Return on (Average) Equity (ROE) are often calculated. Previous studies by Helbok and Wagner (2006b) and Linsley et al. (2006) examined the relationship between disclosures and profitability of banks, thereby measuring profitability by the net profits divided by total assets (ROA). Another measurement that is often reported as a key performance indicator in the annual reports of banks is the ROE, which is the division of net profits by shareholders equity. In order to examine the relationship between bank profitability and risk disclosures by Indian banks, profitability will therefore be measured by ROE.

9.3. STATISTICAL METHODS

The tools are used in this work are,

- Arithmetic Mean
- Variance
- Standard deviation
- Pearson Correlation coefficient
- One & two tailed T-test (at .05 significance level)

9.4. TYPES OF DATA USED

For the study, secondary data is used in form of annual reports of banks. The annual reports were downloaded from websites of each respective bank for the year 2012-2013. Out of population of nationalized banks and private sector banks, by May 2012, annual reports of 27 banks were available on websites of respective banks and therefore they form a sample size of this study..

9.5. DESCRIPTIVE STATISTICS

Descriptive statistics are used to scoring the qualitative & quantitative item, shown in the annual report of the Indian bank.

TABLE 9.1.: SUMMARY DATA OF EACH BANK

BANK NAME	QUALITATIVE SCORE	QUANTITATIVE SCORE	BANK SIZE "000's"	PROFITABILITY
Allahabad Bank	25	28	2043731889	24.24
Andhra Bank	23	32	1462989442	23.04
Bank of Baroda	13	29	5471354403	108.84
Bank of India	21	25	4526027183	47.79
Canara Bank	20	32	4123426086	11.88
Dena Bank	13	27	1134404240	23.15
Punjab National Bank	11	24	4788770363	139.52
United Bank of India	20	27	1146151131	8.64
Union Bank of India	19	28	3118608073	38.93
State Bank of India	29	29	21331583363	210.06
Axis Bank	27	29	3405606584	119.67
Development Credit Bank	21	27	112788239	4.19
HDFC	20	31	407729850	28.49
ICICI	20	25	5367946811	72.20
IndusInd Bank	14	27	733065154	21.83
ING Vysa Bank	18	31	548364438	40.36
South Indian Bank	33	26	497950316	4.03
Yes Bank	20	30	991040774	36.53
Syndicate Bank	17	26	2151223251	33.30

Source : Compiled from Secondary Data.

10.0. SUMMARY OF THE FINDINGS

The purpose of this study has been to know the extent quantity and quality disclosures score related to risk in financial instrument for banks in India as required by AS 32 & Basel II pillar III of financial instruments and to know the relation between the two as well as the relation of each quality and quantity risk disclosure with bank size and bank profitability.

TABLE 9.2.: SUMMARY DATA OF HYPOTHESES TESTING

OBJECTIVES	NO. OF BANKS	STATISTICS	NULL HYPOTHESIS	HYPOTHESIS RESULT	STATISTICAL TECHNIQUE
Objective 1: What is the quantity disclosure score by sample Indian banks?	19	Mean: 0.28 Variance: 0.057	N.A.	N.A.	Descriptive Statistics
Objective 2: What is the quality disclosure score by sample Indian banks?	19	Mean: 0.202 Variance: 0.313	N.A.	N.A.	Descriptive Statistics
Objective 3: Is there any significant correlation exists between quantity and quality disclosure score by sample Indian banks?	19	r value: 0.17 Table value of t: 1.729 Observed t value: -5.988278 Value of P : < .00001	H1 ₀ : There is no significant relationship between quantity and quality score of banks.	Not Significant	Correlation Analysis
Objective 4a: Can the quantity disclosure score of sample Indian banks can be explained by variable of bank size of banks?	19	r value:0.04 Table value of t: 1.729 Observed t value: 3.298 Value of P : 0.001998	H2 ₀ : There is no significant relationship between the quantity of risk disclosures in annual reports of banks in India and bank size in year 2012-2013	Not Significant	Correlation Analysis
Objective 4b: Can the quantity disclosure score of sample Indian banks can be explained by variable of profitability of banks?	19	r value: -0.015587 Table value of t: - 1.729 Observed t value:2.1991 Value of P : .020588	H3 ₀ : There is no significant relationship between the quantity of risk disclosure in the annual reports of banks and the relative profitability of the banks in the period 2012-2013.	Not Significant	Correlation Analysis
Objective 5a: Can the quality disclosure score of sample Indian banks can be explained by variables of bank size of banks?	19	r value: 0.26 Table value of t: 1.729 Observed t value: 3.2098 Value of P : .001998	H4 ₀ : There is no significant relationship between the quality of risk disclosures in annual reports of banks in India and bank size in year 2012-2013.	Not Significant	Correlation Analysis
Objective 5b: Can the quality disclosure score of sample Indian banks can be explained by variable of profitability of banks?	19	r value: 0.050174 Table value of t: 1.729 Observed t value:2.8376 Value of P:0.005459	H 5 ₀ : There is no significant relationship between the quality of risk disclosure in the annual reports of banks and the relative profitability of the banks in the period 2012-2013.	Not Significant	Correlation Analysis

10.1. THE EXTENT OF QUANTITY AND QUALITY DISCLOSURE

The quantity disclosure index contained 37 items. The breakup of these item score consist of 33 items. Mainly located at market risk – interest rate risk, other price risk, there is no disclosure for currency risk in any bank, credit risk are disclosed at good level and liquidity risk are also disclosed.

The quality disclosure index contained 13 items, 4 items were related with relevance, 4 with compatibility, 1 with reliability and 4 with understandability. A close look of above 13 items shows that out of these 7 to 9 items are required as per Basel II. As Basel II is already mandatory in India since more than 2 years the banks are likely to score high in quality score. As the findings of study show the mean value of quality disclosure is 0.71 and minimum being 0.54 and maximum being 0.92 with variances of 0.01. In other words on average 9 items are scored of 13 items by a bank. These findings confirms with the observations that 7-9 items are required as per Basel II norms. It is expected that with making disclosures mandatory, the score shall approach to 1.

The findings of this study suggest that banks in India require more disclosures to meet the requirements of users of information and compete successfully with banks which discloses more. Especially the quantity disclosure requires more attention.

10.2. QUANTITY V/S QUALITY DISCLOSURE

As expected the outcome of hypothesis H1 shows no significant relationship between quantity and quality disclosures. This result is important to further explore co-relationship of quantity disclosure score with bank size and profitability and quality disclosures.

10.3. QUANTITY DISCLOSURE SCORE AND BANK SIZE

The expected outcome of the study was to have no significant correlation between quantity disclosure score and Bank size as it is mandatory requirement as per Indian AS32- which is subset of Basel II disclosure which became effective before 2008- 09/2009-10 for banks in India. The result for the year 2012-13 for 19 banks under study are in line with expected outcome.

10.4. QUANTITY DISCLOSURE SCORE AND PROFITABILITY

The expected outcome of the study was to have no significant correlation between quantity disclosure score and profitability as measured by Return on Equity. The findings are contrary to expectations and show significant relationship with profitability. One reason for this unexpected outcome can be explained by wide variation of ROE value for sample banks with lowest value of 4.19, highest value of 139.52.

10.5. QUALITY DISCLOSURE AND BANK SIZE

The expected outcome of hypothesis H4 has been that there is no significant relationship between quality disclosure and bank size of banks. The findings are in line with the expected outcome.

10.6. QUANTITY DISCLOSURE AND PROFITABILITY

The expected outcome of hypothesis H5 has been that is no significant relationship between quality disclosure and relative profitability of banks. The findings are in line with the expected outcome.

11.0. SUMMARIZED CONCLUSION

To summarize,

1. The quantity disclosure score has the potential to improve for banks in India. This can help the banks to compete more effectively also. It will enable users of information of annual reports to take more informed decisions. Perhaps with introduction of Xtensible Business Reporting Language (XBRL) in India it may be easier for regulatory authorities to expect risk disclosure score closer to 1 in near future.
2. On the similar line quality disclosure score has a lot of potential to improve for banks in India.
3. There is no significant correlation ship of quantity disclosure and bank size for 2012-13, the reason for this may be as it is mandatory requirement.
4. There is significant correlation between quantity disclosure and profitability. This was not expected as disclosure has become mandatory. Perhaps the wide difference is ROE of Banks can explain this correlation.
5. As expected, there is no significant correlation of quantity disclosure and bank size and also profitability.

6. Overall the results are in line with expected outcome expect for quantity disclosure score and profitability co-relation. However both the quantity and quality disclosure score have potential to reach to 1 and it can enhance the utility of risk disclosure for both banks as well as users of information. Overall the results are in line with expected outcome expect for quantity disclosure score and profitability co-relation. However both the quantity and quality disclosure score have potential to reach to 1 and it can enhance the utility of risk disclosure for both banks as well as users of information. The study concludes that sample banks in do follow the financial risk disclosures as required by Indian AS 32/ IFRS 7 in their first year, by way of quantity disclosure less than 0.5 while quality disclosure near to 1, and therefore, there is lot of scope to improve especially the quantity disclosure in the years to come..

12.0. LIMITATION OF THE STUDY

The study is limited to 27 banks. It is based on convenient sampling method rather than random sampling and therefore it has limited validity. The conclusive study require large and more scientific sampling method.

12.1. CONTRIBUTION OF THE STUDY

The present study gave empirical findings on Risk disclosures Practices for financial instruments in line with IFRS 7 and AS 32 for Banks in India and therefore provides empirical evidence in Indian context for further strengthening the literature on risk disclosure by banks.

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APPENDICES

APPENDIX 1: RISK DISCLOSING ITEMS

TOTAL DISCLOSURE IS TO BE CONSIDERED

Qualitative	–	42
Quantitative	–	37

APPENDIX 2: BANKS UNDER STUDY

ALLAHABAD BANK	STATE BANK OF INDIA	PUNJAB NATIONAL BANK
ANDHRA BANK	SYNDICATE BANK	SOUTH INDIAN BANK
BANK OF BARODA	AXIS BANK	YES BANK
BANK OF INDIA	DEVELOPMENT CREDIT BANK	UNION BANK OF INDIA
CANARA BANK	HDFC BANK	UNITED BANK OF INDIA
DENA BANK	ICICI BANK	ING VYASA BANK
INDUSIND BANK		

APPENDIX 3: DETAILING OF DISCLOSURING ITEMS

Section	Qualitative	Quantitative
DF1(scope of application)	Bank has no branches	Bank has no branches
DF2(capital structure)	Summary information of capital instrument	<ul style="list-style-type: none"> • Tire1 capital • Debt capital instrument • Subordinate debt • Other deduction • Total capital
DF3(capital adequacy)	<ul style="list-style-type: none"> • ICAAP policy • Requirement of current business level • CAR/CRAR 	<ul style="list-style-type: none"> • Capital requirement for • Credit risk • Market risk • Operational risk • Tire1 & capital adequacy ratio
DF4(credit risk-general)	<ul style="list-style-type: none"> • Past due & impaired assets • Credit risk management policy 	<ul style="list-style-type: none"> • Gross credit exposure(fund & non fund based) • Geographical distribution • Industry type • Residual contractual • Interest rate sensitivity • Amount of gross NPAs • Net NPAs • NPA ratio • Movement of NPA • Movement of NPA provision • Amount of non performing investment • Provision for NPA investment • Movement of provisionfor depreciation on investment
DF5(credit risk-standardise approach)	<ul style="list-style-type: none"> • Name of ECRAS • Reason (if not) 	<ul style="list-style-type: none"> • Amount of outstanding • Amount of deduction
DF6(credit risk mitigation)	<ul style="list-style-type: none"> • Policies for collateral valuation • Has CRM & CPM put in • If not discuss • Financial collateral • Guarantor & counter parties • Non financial • Information about risk concentration 	<ul style="list-style-type: none"> • Cover of total exposure • Eligible/eligible financial collateral • Other eligible collateral
DF7(securitization)	<ul style="list-style-type: none"> • Objective • Role • Regulatory capital approach • Summary of bank accounting policy • Name of ECAIs 	<ul style="list-style-type: none"> • Total outstanding exposure securitized • Amount of impaired past due asset securitized • Loss recognition • Total amount of securitized exposure retain • Amount retained securitise exposure into a meaningful no. of risk weight bands
DF8(market risk)	<ul style="list-style-type: none"> • General disclosure requirement for market risk including portfolio • Market risk management policy • Trading policy with risk monitoring & mitigation measure. • Standardize duration approach • Securities under HTF • Securities under AFS • Derivatives enter into AFS • Risk management & reporting based parameter • Analysis of risk profile & mitigation strategy • Forex open position limit 	<ul style="list-style-type: none"> • Capital requirement for market risk • Interest rate risk • Equity position risk • Forex risk
DF9(operational risk)	<ul style="list-style-type: none"> • Risk policy in place • RCSA has been rolled out to zone • ORMC has been constituted • Disaster recovery policy • Operating risk capital assessment 	<ul style="list-style-type: none"> • Capital charge on operational risk
DF10(interest rate risk in banking book)	<ul style="list-style-type: none"> • Indicate wheather NII is measured as per ALM guideline • Indicate wheather earning at risk is arrived under thetraditional gap analysis • Changes in bank's market value of equity 	<ul style="list-style-type: none"> • Changes in net interest income • Changes in market value of equity

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