Looking Forward to Financial Risk Disclosure Practices by Malaysian Firms

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Abstract: This study examined the financial risk disclosure practices in Malaysia and content analysis is employed to analyze the level of financial risk disclosure. In order to reduce the information asymmetry with more disclosures in annual report, the financial risk disclosure practices can be subject to investigate. The importance of financial risk disclosure Include mandatory and discretion is revealed after the Asian financial crisis in 1997 in order to reduce uncertainties for investors. The main element of focus is on financial risk disclosure which is foreign exchange rate risk, interest rate risk, commodity risk, credit risk, and liquidity risk. It was found that the level of financial risk management disclosure has a score of 38 out of one hundred. There is potential to provide proposals which can explain and introduce how the firms can manage and disclose financial risks in their annual reports as a guideline in Malaysia. Another important reason is due to the regulations that cover all the elements of financial risk in mandatory disclosure in detail at the end of 2010 by accounting standards in Malaysia (FRS 132, FRS 139 and FRS 7). There is no proposal to provide a detailed guideline on all the elements of financial risk disclosure even voluntarily until the end of 2011 such as (AICPA, 1994; ASB, 2003; CICA, 2002; ICAEW, 1997, 1999b, 2002) which explains the narrative of risks and good practices in annual reports in Malaysia.

Key words: Financial Risk Disclosure, FRS (Financial Reporting Standards), Mandatory, Discretionary disclosure, and Malaysia

INTRODUCTION

The aftermath of the Asian financial crisis in 1997, the importance of financial risk management was highlighted as a critical issue amongst Malaysian companies. According to (Davidson, 2010), prior to that, very little attention was paid to this matter by Malaysian’s companies. Financial risk management or FRM for short can be defined as the development and implementation of a set of system that controls financial risks. FRM is a segment of business that promotes transparency in the business (Patel, Balic, & Bwakira, 2002) to decrease the asymmetry of information that takes place between the investors and managers. FRM is a taxonomical approach for a company to manage and organize its information regarding interest rate risks, foreign exchange rates, commodity prices, liquidity risk, and credit risk (Taylor, Tower, & Neilson, 2010).

According to Bursa Malaysia, listed companies are mandated to disclose in their annual report how much they have been compliant with the corporate governance code. Some of the best practices under the code of Corporate Governance include transparency if the information that is reported in the annual report, the structure that is used, risk management and the measurement of risk in a company. The increase of the risk management in corporate governance also increases the awareness in the committees at the board level as in the audit, risk, and financial risk committees. It is very important to analyze the financial risk disclosure in a company (Dell’Atti, Papa, & Cucaro, 2010).

The current changes in the business environment has caused companies to focus on the important needs in conducting transactions globally and the financial instruments used; this has caused the companies to be more motivated in disclosing their corporate financial risk (Dobler, 2008). This research will examine the disclosure of financial risk management practices in Malaysian companies’ annual reports; the research is based on seven key questions and the index that is used has been taken from Taylor et al, (2010) to get individual answers based on the annual report of these companies as listed in Bursa Malaysia.

The sample of 100 non-financial companies that have been listed in 2011 and have adopted the FRS132, FRS7, and FRS139 were chosen. Both the discretionary and mandatory information were measured. Some of the items under FRM disclosure include credit risk, commodity prices, foreign exchange, interest rate risk, and liquidity risk. The study is organized as follows: section 2 comprises of the regulatory reviews while section three consists of the research questions; section four represents the four samples and the methodology that was used. The results, discussion, and conclusion are presented in section five, six, and seven respectively.

Regulatory Reviews of Financial Risk Disclosure:

In recent times, derivatives and financial instruments are becoming more popular and this has instigated regulatory bodies to initiate new accounting procedures to expose discrepancies in balance sheets. Ever since the
currency crisis in South East Asia in 1997 as well as the much publicized disaster on corporate disasters, the critical need for disclosure of financial instruments to report risks has become critical (Rahman, 1998).

**Malaysian Accounting Standards Board (MASB):**

Keeping in line with international development on this matter, firms in Malaysia are also needed to adhere with the regulations set by MASB from the year 2001 onwards; this policy is known as the MASB 24 Financial Instruments: Disclosure and Presentation which was adopted from the International accounting standards namely IAS 32 Financial Instruments: Disclosure and Presentation.

After Malaysia started following the IFRS or International Financial Reporting Standards, FRS 132 Financial Instruments on Disclosure and Presentation was decided to be mandatory in the year 2006. The Malaysian Accounting Standards Board, however, postponed the total adoption of FRS 139 Financial Instruments which is on Recognition and Measurement. As such, for the time being, companies in Malaysia except for financial institutions do not need to adhere to the FRS 139 Financial Instruments. A valid excuse for this move was to assist firms that were ill equipped to change their accounting reporting which was always based on historical cost data into fair value accounting as is the requirement by FRS 139. In fact, even in the international setting, this issue is still being discussed and developed.

The main objective of FRS 132 as a standard is to implement the rules for using the financial instrument to be reported as equity or liability and to offset the assets and liabilities. It is related to the financial instrument’s classifications based on the organisation that is reporting: as in assets, liabilities, and equity based on the view; categories of interest, dividend, profit, and loss in addition to the situation where the assets and liabilities are offset. These rules are standards that are complementary to the principles or rules used to recognize and measure the assets and liabilities in the FRS 139 Financial Instruments: Recognition and Measurement and also the FRS 7 Financial Instruments: Disclosures. Using these standards enables the identification of risks that may be caused by the use of derivatives and financial instruments.

The factors that influence timing, amount, and certainty of a firm’s future cash flows relates to financial instruments and policies related to accounting that are applied to the instruments. In addition, the use of financial instruments by an organization, the risks involved with these instruments and the policies used to control risk are some of factors studied. The FRS 7 Financial instrument: Disclosure (equivalent of IFRS 7) and FRS 139 Financial Instruments: Recognition and Measurement (equivalent of IAS 39) was enforced beginning from the 1st of January 2010.

<table>
<thead>
<tr>
<th>Table 1: Financial risk summary inclusive of the MASB standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial risk</td>
</tr>
<tr>
<td>Foreign exchange</td>
</tr>
<tr>
<td>Liquidity risk</td>
</tr>
<tr>
<td>Credit risk</td>
</tr>
<tr>
<td>Interest rate risk</td>
</tr>
<tr>
<td>Commodity price</td>
</tr>
</tbody>
</table>

**Risk Disclosure in Annual Reports:**

For the purpose of identifying the committee’s responsibilities, Bursa Malaysia (2000) established some policies that the board of directors must enforce some internal controls and have a sound risk management program.

To meet the Bursa Malaysia’s requirements that were established in 2007, the reporting functions to report risk is inclusive of:

(a) The correct management of risk management processes by the necessary departments and to report to the Risk Management Committee; and (b) the setting up and monitoring of the Risk Management Committee which is required to report to the board of directors regularly determined by them.

(b) Reporting: The Risk Management Committee is to report direct to the board of directors in charge of this portfolio.

Based on paragraph 56 of the FRS132 Financial Instrument – Disclosure and Presentation, a particular requirement exists that requires the organization to disclose the financial risk management goals and policies which also involves the policies for hedging all the key forecasting transactions that uses hedge accounting. Paragraph 58 of FRS132 Financial Instrument also points out that each organization should give a report of their hedging, the risks involved and a report of the financial instrument assigned as the hedging tool and for the fair value to be stated in the balance sheet.

The organization should also reveal the different kinds of market risk including interest rate risk and the extent of the risk with the current interest rates and the maturity dates or contracts’ re-pricing dates. For credit risk, the organization should report the value of its highest credit risk exposure in the balance sheet; this does not include the fair value of any held collateral if other parties do not carry out their duties under the financial tools and an appropriate portion of the credit risk as well.
Disclosure regulations improve the efficiency of the market (Healy & Palepu, 2001) and influence, although arguably, the credibility of financial disclosure and, hence, public confidence in the capital market increases. However, although regulations are efficient in increasing the level of disclosure, the evidence found no impact in the quality of information (Konishi & Ali, 2007; O'Shea, Worthington, Griffiths, & Gerace, 2008; Rajgopal, 1999).

**Contribution to Knowledge and Signaling Theory:**

In order to improvement of quality and quantity of the financial risk disclosure which can be part of regulators’ interest not only observing with regulations but also in meeting the needs of various user groups of annual reports in Malaysia after Asian financial crisis in 1997. This study would answer the calls for improving financial risk disclosure and hope to answer the numerous calls made for improving risk disclosure.

By Signaling theory (Spence, 1973) may give details the motivation behind the financial risk disclosure as firms would achieve the more benefits from making additional financial risk disclosure. In the current difficult business environment, firms may decide to disclose additional information to send signals to the market that additional requirements are not needed.

Regulation may also play as a mechanism to increase disclosure. There is a need for regulation in the imperfect and incomplete market. In the perfect and complete market there is no need for accounting regulation(O'Shea et al., 2008).

**Concept of Financial Risk Management:**

FRM is a taxonomical approach for a company to manage and organize its information regarding foreign exchange rates, interest rate risks, credit risk, commodity prices, and liquidity risk (Taylor et al., 2010).

**Foreign Exchange Risk:**

For firms that are exposed to foreign exchange risk, they should enclose these risks as well. The firm must include information that portrays the possibility of any loss that it might incur from future earnings, fair value and a change in the cash flow due to fluctuations in the currency of foreign market prices in the near future. As an example, a firm that has made a borrowing in a foreign currency is exposed to the risk caused by exchange rates fluctuations and interest rates, so these risks should also be highlighted.

**Interest Rate Risk:**

Interest rate risk is described as the risk that is carried by assets that bear interests as in loans and bonds given the differences in the interest rates. Normally, as the rates go up, the fixed rate on the bond price will decrease and vice versa. The bond’s maturity duration is normally used to calculate the interest rate risk. Asset liability management is a terminology used to describe the whole group of techniques pursued to cope with risk in the normal management of the enterprise. The risks on interest rates can be decreased using hedging on bonds, fixed income tools or fixed-for-floating interest rate exchanges according to (McNeil, Frey, & Embrechts, 2005).

**Credit risk:**

Credit risk is described as the investor’s risk of loss that is derived from another party that borrows but does not fulfill the payment terms; this is known as a default. Some of the investor’s losses are decreased cash flow, increased collection costs, and lost principal and interest that could be caused by various situations. Some of these situations are such as a buyer that defaults on the mortgage payment, line of credit, credit card, or any other loan repayment. The firm will then be unable to repay their own fixed or floating charge that has been made on the assets of the firm, When a business or buyer does not fulfill the payment as stated on the invoice as due, the business would then be unable to pay the salary of their employees on time or when a government bond issuer does not issue the payment when it’s due then the insolvent insurance firm is unable to pay the policy obligation; the insolvent bank will then be unable to refund the depositor; the government however does provide bankruptcy protection to the insolvent business or individual (Frenkel, Karmann, Scholtens, & Scholtens, 2004).

**Commodity Price:**

Commodity risk is defined as the future market value uncertainties and the future income’s size which is caused by commodity price fluctuation. Some of the commodities include gas, metals, electricity, grains, etc. The risks that an enterprise has to deal with when it comes to commodity include: Quantity risk, Price risk ($\text{Risk from drastic movements in the world market prices, exchange rates, and difference between local and world prices}$), Political risk and Cost risk ($\text{Input price risk}$). According to (Prasad & Fund, 2003), the main four types of groups that are faced with commodity risk can be broadly named as Buyers (commercial traders, cooperatives, etc.) who are faced with price risk from the time of the up-country purchase and sales, normally at
the ports, to the exporter; Producers (plantation companies, mining companies, and farmers) who are faced with price risk, quantity risk and cost risk (based on the prices of inputs); Exporters who are faced with similar risks from purchase at the ports and sales in the targeted market and may also be faced with political risks due to export licensing and foreign exchange rates; Governments are faced with quantity and price risks due to tax incomes, especially when tax rates increase when the commodity prices go up (as in the case of energy exports and metals) or when other payments or support are dependent on the commodity prices levels.

**Liquidity risk:**

Liquidity risk is described as the risk associated with the fact that one cannot trade an asset or security fast enough in order to avoid a loss or gain a profit in the market. Market liquidity is defined as the absence of market liquidity when one is unable to sell an asset which is ultimately a form of market risk. This process can be identified through the broadening of the bid or offer, creating explicit reserves in the form liquidity, prolonging the holding period for VaR calculations, Funding liquidity is risky and can be a liability, cannot be met when they are due, can only be met at a non-profitable price, can be systemic or name-specific.

**MATERIAL AND METHOD**

**Content analysis of FRM Practices:**

In this study, there are different stages of content analysis that will be researched. The most important aspect of the various stages where the content is classified and coded is in the development and selection category. According to Beresford and Cowen (1976), the categories describe the happenings of the past years and they’re used to benchmark the progress and changes indicated in the reports. Past literature was reviewed to come up with a list of these items and categories. A current research conducted by Taylor et al., (2010) involved developing an index for the all financial risk categories that cover both discretionary and mandatory which should be disclosed in the annual reports. This research used this list of these items and categories to develop the index for this study. The situation in Malaysia was examined to look for mandatory and voluntary reporting or disclosure on financial risks over the usual routine regulations.

**Table 2:** Financial risk management categories index based on Taylor et al., (2010).

<table>
<thead>
<tr>
<th>Financial risk categories</th>
<th>voluntary and Mandatory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>Related to the usage of financial instruments</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Designates which of the financial assets are represented</td>
</tr>
<tr>
<td>Credit rate risk</td>
<td>Areas of significant focus</td>
</tr>
<tr>
<td>Credit loss</td>
<td>Master netting arrangements to alleviate disclosure</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Maximum exposure</td>
</tr>
<tr>
<td>Credit risk</td>
<td>How it came about</td>
</tr>
<tr>
<td>modified in financial asset related to credit risk</td>
<td>Amount of difference in the fair value of loan or receivable attribute</td>
</tr>
<tr>
<td>Change in the fair value of any related credit derivatives or similar instruments</td>
<td>Since the receivable or loan was designated</td>
</tr>
<tr>
<td>Changes in credit risk</td>
<td>Amount of change in the fair value of financial liability attributable</td>
</tr>
<tr>
<td>Describe the FRM aims and policies and processes for managing risks</td>
<td>Associated with financial instruments, for example, risk reporting, policies and practices for managing risks</td>
</tr>
<tr>
<td>Exposure to liquidity risk</td>
<td>Related to the usage of financial instruments and how it came about</td>
</tr>
<tr>
<td>Level of interest rate risk</td>
<td>Related to the usage of financial instruments</td>
</tr>
<tr>
<td>For each type of market risk</td>
<td>An entity shall disclose a sensitivity analysis</td>
</tr>
<tr>
<td>Financial liabilities</td>
<td>Discovery of a maturity analysis that portrays the residual contractual liabilities.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>Effective interest rates</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>Indicates which of the financial assets and financial liabilities are exposed</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>Maturity dates and/or contractual re-pricing</td>
</tr>
<tr>
<td>In respect of credit risk representation</td>
<td>A description of collateral held as security and other credit enhancements.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>How it came about</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>Related to the usage of financial instruments</td>
</tr>
<tr>
<td>Market risk (commodity price risk)</td>
<td>Related to the usage of financial instruments</td>
</tr>
<tr>
<td>Market risk (currency risk or foreign exchange risk)</td>
<td>Related to the usage of financial instruments</td>
</tr>
<tr>
<td>Risk arising from use of financial instruments</td>
<td>An entity would describe the important methods which used to measure</td>
</tr>
<tr>
<td>To manage any financial instrument risk experience</td>
<td>Discussion of controls that are in place</td>
</tr>
<tr>
<td>The difference between the financial liabilities involving amount and the amount the entity</td>
<td>Would be contractually necessary to pay at maturity to the holder of the obligation</td>
</tr>
<tr>
<td>Any risk in value of financial instrument employ</td>
<td>Summary of each quantitative information about entity’s exposure</td>
</tr>
</tbody>
</table>

**Research Questions:**

Our questions follow seven items, for answering each item we need to refer to financial risk management index which can be disclosure mandatory or voluntary in annual reports.
1. Do Malaysian companies have any practice in order to financial risk management objectives and policies (mandatory and discretionary) in annual reports?
2. Do Malaysian companies have any practice to disclose foreign exchange risk in order to managing the financial risks (mandatory and discretionary) in annual reports?
3. Do Malaysian companies have any practice to disclose interest rate risk in order to managing the financial risks (mandatory and discretionary) in annual reports?
4. Do Malaysian companies have any practice to disclose credit risk in order to managing the financial risks (mandatory and discretionary) in annual reports?
5. Do Malaysian companies have any practice to disclose commodity price in order to managing the financial risks (mandatory and discretionary) in annual reports?
6. Do Malaysian companies have any practice to disclose liquidity risk in order to managing the financial risks (mandatory and discretionary) in annual reports?
7. Do Malaysian companies have any practice on hedging instruments in order to managing financial risks (mandatory and discretionary) in annual reports?

Sample Selection:
The sample of 100 non-financial firms that were listed in Bursa Malaysia as at year ending 2011 was chosen while supposed the FRS7, FRS132, and FRS139 were adopted by the firms. All reports were downloaded from the main website of Bursa Malaysia; it was used in the calculation of any practice of financial risk disclosure by a specific dividend that was carried out by the firms based on the research questions. The documents used were in the English language. A table was used to answer each question to find out the number of firms that practiced each category that was mandatory or voluntary in terms of financial risk disclosure.

Table 3: The distribution of sample selections from the listing board in Malaysia

<table>
<thead>
<tr>
<th>Main board</th>
<th>MESDAQ</th>
<th>Second board</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of company include in the test</td>
<td>50</td>
<td>20</td>
<td>30</td>
</tr>
</tbody>
</table>

One and zero values were used to score the practices for each question. The sum of all numbers were calculated and results were divided to the total number of questions to calculate the percentage of practices used to manage financial risk disclosure, either mandatory or voluntary based on the index, as developed by Taylor et al. (2010).

\[
\text{Percentage of practice to manage financial risk disclosure} = \frac{\sum \text{score of one (yes) or zero (No) for each questions}}{\text{number of companies}} \times 100
\]

Results:
The findings of the research are offered based on the main research questions, sub-questions, and the index that was used as reflected in the sections above. Table 4 displays the findings of the answers to the questions and the scores obtained for each category of financial risk disclosure.

For explanation, for example, the most important function of FRS132 is highlighted as the answer to question 1. At this point of time, many firms have already adapted FRS132. The findings also indicate that most firms have implemented a committee to be in charge of risk management since 80% of the firms had stated their policies and objectives related to financial risk management as required by FRS132, Paragraph 56 & 57. This shows that most of the firms comply with this standard when reporting information in the annual reports. In this respect, the chosen items comprise of financial instruments, related risks and the policies for managing these risks. Many of the firms report the policies that they adhere to but further details on this matter are not reported.

The second question was on the disclosure of foreign exchange risk and it was discovered that the majority of companies do not report this matter and further improvement in this practice is required. A major drawback is that there is no guideline on how firms should disclose their foreign exchange rate and related risks. This process is seen in the FRS7 introduced in 2010 and firms are more likely to comply with this requirement in their annual reports after this. However, the disclosure process on financial risk management requires more improvement from the side of firms when it comes to reporting in their annual reports. A summary of the obtained scores are shown in the table below.

Table 4: Summary of results and scores

<table>
<thead>
<tr>
<th>Questions</th>
<th>Main board</th>
<th>MESDAQ</th>
<th>Second board</th>
<th>Score</th>
<th>Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question1 (answer score yes=1 and No=0)</td>
<td>42</td>
<td>14</td>
<td>24</td>
<td>80%</td>
<td>FRS132, 2006</td>
</tr>
<tr>
<td>Question2 (answer score yes=1 and No=0)</td>
<td>6</td>
<td>2</td>
<td>2</td>
<td>10%</td>
<td>FRS7, 2010</td>
</tr>
<tr>
<td>Question3 (answer score yes=1 and No=0)</td>
<td>37</td>
<td>12</td>
<td>22</td>
<td>71%</td>
<td>FRS132, 2006</td>
</tr>
</tbody>
</table>
Discussion:

Evidence from the findings show that most firms have followed the guideline set in the FRS132 in disclosure of information in their annual and financial reports since the practice came into place in 2006. The financial risk items here such as interest rate risk and credit risk have 80% of coverage from the scores. This is a good indication that Malaysian firms are following the requirements set by the regulators for the past five years from 2006 to 2011. The lower percentage of other financial risk components could be caused by the later adoption of FRS7 and FRS139 which only came into place in 2010. The allowance of one year to comply with the regulations gives the firms time to prepare and identify the risks involved and how they can reflect it in their annual reports.

The Asian financial crisis in 1997 pointed out the weakness and negligence of sound financial risks practices by firms. The MCCG has however, prepared several code of corporate governance in the year 2000 which was also revised in year 2007 (later revised again in 2012), to assist the firms in managing their risks and the proper practices to follow in disclosure. The findings reveal that more attention needs to be given to the area of managing risks and following the practices that have been set. These findings are supported by the results of researches by Ameer (2009), Amran et al. (2009), Ghazali (2012), and Othman and Ameer (2009). Their conclusions also suggest that Malaysian firms should improve their risk on financial disclosure practices where there is further room for improvement.

Conclusion:

The Asian financial crisis in 1997 made companies become sensitive to the management of financial risks. In order to manage the risks faced by the businesses, the firms should be first made aware of these risks. It was analyzed how Malaysian firms and regulators can manage their financial risk further with more disclosures in order to decrease the information asymmetry required for raising capital and decreasing the cost of the capital (Chen & Gao, 2010). The percentage of firms that managed their financial risk based on the developed index and designed questions, was examined. The score of 38% of firms is aware of financial risk disclosure from 1997 till 2011. It is suggested that voluntary disclosure might help this situation base on signaling theory that suggests to send signal to market for gaining more benefits by mechanism of reducing the information asymmetry with the establishment of new guidelines; and practices by regulators in the form of FRS7, FRS132, and FRS139 in terms of financial risk disclosure and the mandatory sections. The finding contributes that informing regulator the score of the firms try to managing the financial risk after Asian financial crisis 1997 in Malaysia. One of the essential findings in the area of financial risk management is that there is not any proper and reliable proposal in emerging market on how the firms can describe the risks and explain how the practices are conducted when it comes to risk disclosure and annual reporting in emerging market as practiced in developed country (AICPA, 1994; ASB, 2003; CICA, 2002; ICAEW, 1997, 1999b, 2002). Future research could be carried out in the area of content analysis and to find out the effects of some of the corporate features and mechanisms in the financial risk disclosure level among Malaysian firms. Future research could also be carried by analyzing the determinants and effect of financial risk disclosure after the adoption of FRS7 and FRS139 by firms since the firms were given time to adopt the new policies when reporting in their annual reports.

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Farahnaz Orojali Zadeh and Alireza Eskandari are doing their PhD at the University Teknologi Malaysia, International Business school (IBS). In this article, we tried to highlight the importance of financial risk and any practices of hedging and managing those important risks by Malaysian firms and others in terms of providing proposals by regulators, which can help firms to have best practices in this matter. Most of countries around the world are worried about financial risks given the debt crisis in Euro domination such as the Greece and Spain recession in 2011 and 2012 respectively. Financial risk is always the focus of attention.
Financial Risk Is Not An Earthquake That Happens Suddenly; The Most Of The Risks Are Manageable:

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