

The Determinants of Risk Disclosure in the Indonesian Non-listed Banks

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Abstract

The study aims to explain the extent of risk disclosure of Indonesian non-listed banks' annual reports and to investigate the determinants which drive non-listed banks to disclose their risk. Risk disclosure is measured by Indonesian risk keywords divided by total number of sentences in annual reports. The result showed that total number of risk keyword, sentences and risk disclosure in annual reports has an upward trend. Leverage and profitability have negative association with risk disclosure. Aggregated firm characteristics affect non-listed banks to disclose their risk. This result constructs a new method for measuring risk disclosure and enriches the literature related to agency and signalling theories.

Keywords: *disclosure; annual reports; risk keyword; non-listed banks.*

1. Introduction

A major failures of risk assessment, a lack of transparency, and an inadequate risk reporting were the factors which contributed in the financial crises in 1997 and 2008. Since then, transparency and disclosure of annual report became an important ingredients of banking sector stability. Because of highly confronts with risk and plays a crucial role in the business and economics, banking sector is controlled by many regulations such as disclosure of annual report. In addition, investors need company information in annual reports in more detail for considering before making financial decisions.

Indonesia is a developing country which has an emerging market and a large total bank. In addition, Indonesia was weak in risk management practice and corporate governance, lacks transparency and disclosure (Kurniawan and Indriantoro, 2000). A very little previous research examined risk disclosure in non-listed banks and have tended to focus on listed companies. An absence of transparency is one of the drawbacks of non-listed firms.

2. Literature Review and Hypotheses

Disclosure occurs when information is released for the public pertaining to companies' activities and performance evaluation. Some regulations have been issued by the Bank of Indonesia (BI) in order to minimise the risk for banks. Banks are mandated to provide their performance through annual reports transparently. Moreover, the third pillar in Basel is concerned with market discipline, and requires banks to increase disclosure to the market. Prior

research exhibited that risk disclosure was affected by firm characteristics, the empirical findings were unclear.

2.1 Size

In order to minimise asymmetric information between managers and users, big companies which have a complicated business will disclose more than small firms. As the consequences, large companies have more stakeholders; more complex in the transaction and activities comparing to small companies. Moreover, they will be paid more attention by public. Along with that the companies should be more transparent in reporting their performance. In doing so, a large company will be able to pay finance consultants and analysts to produce annual report in more detail. Aljifri et al. (2014) found a negative association between the level of disclosure and firm size. While, Popova et al. (2013) revealed that there is no correlation between risk disclosure and firm size.

2.2 Liquidity

When firms have lower liquidity, they will disclose more and be aware of information in order to minimise information costs. Yet, Marshall and Weetman (2007) highlighted that based on the signalling theory, the high liquidity firms will disclose more and show better signals than the firms with low liquidity. While Aljifri et al. (2014) concluded that the relationship between disclosure and liquidity is insignificant.

2.3 Profitability

A positive correlation between profitability and disclosure was found by Al-Maghzom et al. (2016) and Jaya et al. (2016). Signalling theory suggests that more profitable firms disclose more to inform their stakeholders about their good performance. Agency cost theory asserted less profitable firms disclose more to explain the reason about their worst financial performance (Inchausti, 1997). While Aljifri et al. (2014) exhibited that profitability and disclosure has an insignificant association.

2.4 Leverage

Agency theory states that firms with higher levels of leverage tend to disclose more information voluntarily in order to satisfy creditors and remove the suspicions of wealth transfer to shareholders (Popova et al., 2013). Signalling theory states that association between leverage and risk disclosure has unclear direction.

2.5 Earnings reinvestment.

Dividends are still debated, the companies perceive giving high dividends is good for shareholders and company, however paying low dividends is good as well. To compensate for a high risk investment, firms which have low disclosure are expected to pay higher dividends, this means that earnings reinvestment will be low (Baker and Powell, 2012). Shareholders need dividend policy information to assess and analyse the possibility of return that would be obtained if they invest in that company.

A decision of dividend payments policy is an important thing concerning whether cash flow will be paid to investors or will be retained for reinvestment. A company with a high reinvestment rate plan will provide a lower dividend at the beginning of the period because the company will invest some of the profits for expansion (reinvestment), however, investors will receive a higher dividend in the future (Bodie et al., 2011). Companies will pay dividend to compensate investors equal to the level of risk of their investment. To compensate a high risk investment, firms which have low disclosure are expected to pay higher dividend (Baker and Powell, 2012). Thereby, a company which has a reinvestment policy should disclose more in order to make sure the investors who reinvesting the earnings, will get a higher earnings in the

future. However, very little research tested relationship between earning reinvestment and risk disclosure.

Based on those explanation, the following hypotheses are:

(H1): There is a positive association between risk disclosure and firm size.

(H2): There is a positive association between risk disclosure and liquidity.

(H3): There is a positive association between risk disclosure and profitability.

(H4): There is a positive association between risk disclosure and leverage

(H5): There is a positive association between risk disclosure and earnings reinvestment

(H6): There is an association between risk disclosure and firm characteristics (aggregately).

3. Method

The 269 of data was collected from 88 Indonesian non-listed banks which had issued annual reports above the year 2008 to 2012, and it tested by partial and multiple regression. The independent variables are : firm size is proxy by assets; liquidity is proxy by Loan to Deposit Ratio (LDR); profitability is proxy by Return on Equity (ROE); leverage is proxy by Debt/Assets; earnings reinvestment (ER) is measured by $b = (EPS-DPS)/EPS$ (Ryan, 2007). Kravet and Muslu (2013) defined that risk disclosure can be reflected by the total number of sentences with at least one risk-related keyword. The code tags a sentence as risk-related if the sentence includes at least one of the following risk-related keywords: “can/cannot, could, may, might, risk*, uncertain*, likely to, subject to, potential*, vary*/varies, depend*, expos*, fluctuat*, possibl*, susceptible, affect, influenc*, and hedg*”. This research also refer to Elshandidy et al. (2013, p. 17) who employed the following words: “risk*, loss*, decline (declined), decrease (decreased), less, low*, fail (failure), threat, verse (versed, reverse, reversed), viable, against, catastrophe (catastrophic), shortage, unable, challenge (challenges), uncertain (uncertainty, uncertainties), gain (gains), chance (chances), increase (increased), peak (peaked), fluctuate*, differ*, diversify*, probable*, and significant*”.

The dependent variable is risk disclosure (RD) which is measured by number of Indonesian risk keyword divided by number of Indonesian sentences in annual report. The risk keyword were translated into Indonesian language because most of the annual reports were in Indonesian. The QSR-N6 was employed for counting total number of Indonesian risk keyword in the annual reports.

Statistical model

$$RD = \beta_0 + \beta_1 \text{size} + \beta_2 \text{Liquidity} + \beta_3 \text{Profitability} + \beta_4 \text{Leverage} + \beta_5 \text{Earning reinvestment} + \varepsilon$$

4. Empirical results and discussion

4.1 The extent of risk disclosure

Table 4.1 exhibits that average number of Indonesian risk keyword in the non-listed banks annual report has an upward trend. Even though in 2009 dropped, the trend of average number of sentences increased sharply. The number of RD in 2008 to 2010 inclined, but it dropped in 2011, finally it sharply increased in 2012. This condition showed that non-listed banks had tried to report their risk in more transparent.

4.2 The determinants drove non-listed banks to disclose risk in annual reports

Table 4.2 provides the overall minimum, maximum, mean and standard deviation of the determinants and RD. The partial correlation and regression results are shown in table 4.3 and table 4.4.

4.2.1 Size

Table 4.3 and table 4.4 show that assets did not affect RD, therefore this study reject the (H1). This indicates that non-listed banks revealed their risks in the annual reports were not

based on assets. They may have been considering other factors when they reported their risk in more detail. This study is not in line with agency and signaling theories; however, this result is consistent with Popova et al. (2013) who all agreed that firm size has an insignificant association with risk disclosure.

4.2.2 Liquidity

A company with a more transparent performance report not only generates the increasing of liquidity, but also has a robust trustworthiness by stakeholders. The statistical result exhibited that liquidity did not affect RD (table 4.3 and table 4.4). The results indicate that liquidity in non-listed banks did not affect banks to report their risk more transparently. This is accordance with Elzahar and Hussainey (2012) who asserted that the relationship between disclosure and liquidity is insignificant. Finally (H2) is rejected and this is not consistent with agency and signaling theories.

Table 4.1 The average number of risk keyword, sentences and risk disclosure

	2008	2009	2010	2011	2012	Average
Risk keyword	416.47	359.52	416.04	565.88	661.71	491.49
Sentences	7,489.15	5,443.73	6,261.44	7,880.20	9,141.80	7,069.12
RD	0.0848	0.0933	0.0962	0.0861	0.0984	0.0942

Table 4.2 Frequently distribution of the determinants and risk disclosure

Variables	Mean	Median	Std. Dev	Min	Max	N
Assets	1.1084	.4400	1.45466	.01	6.45	269
LDR	.9958	.8700	.66709	.17	6.20	269
ROE	.1586	.1300	.15386	-.26	.99	269
Leverage	.8236	.8700	.16993	.01	1.24	269
ER	.7789	1.0000	.51626	-2.92	1.79	269
RD	.0942	.0800	.06249	.01	.46	269

Table 4.3 The Pearson's correlation of the determinants and risk disclosure

	Assets	LDR	ROE	Leverage	ER	RD
Assets	1					
LDR	-.076	1				
	.108					
ROE	.161**	-.232**	1			
	.004	.000				
Leverage	.126*	-.111*	.177**	1		
	.020	.035	.002			
ER	.063	.064	-.109*	-.188**	1	
	.153	.146	.037	.001		
RD	.088	-.020	-.108*	-.146**	.062	1
	.075	.375	.038	.008	.154	

p-values are given in parentheses. N=269. **correlation is significant at the 0.05 (1- tailed)

4.2.3 Profitability

Signalling theory asserts that highly profitable firms deliver signals to show their good performance more transparently. However, the result exhibited that ROE has a significant negative effect on RD. This is not in line with agency theory that suggests companies with high profit will disclose more for continuing their position (Inchausti, 1997). This might happen because banks with low profit will explain their condition to the public in more detail in order to

make sure the existence of the firm and explain why they had this condition. Since the result contradict with the hypothesis, therefore (H3) should be rejected.

4.2.4 Leverage

Companies with high leverage will give more narrative and meaningful information in their annual report (Jensen and Meckling, 1976). As shown in table 4.3 and 4.4, this can be mentioned that there is a negative association between leverage and risk disclosure. Actually, banks with high leverage is normal because the main source of fund is from debt. Ramadan (2012) mentioned that debts could benefit a company in terms of earning profit and creating opportunities for investment. On the other hand debts may harmful and risky for the firms when they are not able to pay debts back plus the interest. The lenders can claim bankruptcy if the bank cannot repay the debts. This may have been because banks were unwilling to explain leverage in more detail, due to leverage could sending a negative image for stakeholders related to bankruptcy. The statistic result exhibited that leverage has a negative effect on RD. It can be concluded that non-listed banks with high leverage will not disclose their performance more transparent. The result contradicts with the hypothesis, therefore (H4) is rejected.

4.2.5 Earnings reinvestment

Table 4.3 presents that RD did not have a relationship with earnings reinvestment. The result is not in line with Baker and Powell (2012) who asserted that in signalling theory, firms with low disclosure are supposed to pay higher dividends (low earnings reinvestment). In other words non-listed banks reported risk in more detail did not merely because of earnings reinvestment, but possibly was affected by other factors. Hence, the (H5) is rejected.

Table 4.4 Summary of the result of OLS regression risk disclosure

Variables	β	T	Sig t
Assets	0.119	1.926	0.055
LDR	-0.054	-0.867	0.387
ROE	-0.113	-1.773	0.077* (*significant at the 10%)
Leverage	-0.144	-2.295	0.023** (**significant at the 5%)
ER	0.019	0.310	0.757
Adjusted R square = 0.028; F = 2.533; F sig = 0.029; DW = 1.553			

4.2.6 Firm characteristics

Table 4.4 shows that firm characteristics aggregately influence RD. Only 2.8% of RD was explained by firm characteristics, namely: size, liquidity, profitability, leverage, and earnings reinvestment. This study accepted (H6), however the adjusted R square (0.028) was very small. Indeed that the extent of risk disclosure of non-listed banks tend to increase but firm characteristics was not merely the factors which drove them to report the risk in more detail. This might be 97.2% of RD was explained by other variables which are not tested in this model. Finally, the regression model in this study was not fit for testing the factors affecting non-listed banks in disclosing risk. This condition also happened in Japan, even though the quality of disclosure was tended to grow, the vastness of information was still in moderate (Globerman and Singleton, 2009). This condition could be driven by other factors such as regulations including mandatory and voluntary disclosure; corporate governance; cost; political or other firm performances. The regulations could push banks to report their firm's performance in more transparent. In addition, companies might afraid to disclose their condition, because competitors can read their strategies. Along with that the managers might consider cost and benefit of disclosure, and what the contents of information will be reported such as the contents may depend on the quality of the information will be revealed, whether they are presenting bad or

good news. According to Putra and Simanungkalit (2014), due to regulations give flexibility in reporting firm performance with adequate, fair and full disclosure level, hence the companies could just report for adequate information.

5. Conclusion, limitation and suggestions for further research

The trend of the extent of risk disclosure rose gradually. Leverage and profitability have significant negative association with RD, meanwhile size, liquidity and earnings reinvestment did not have relationship with RD. The results contradict with agency and signaling theories, this means that the theories are inconclusive for predicting the direction of association between RD and firm characteristics. Even though the F was significant, the adjusted R square was very small, hence the regression model was not fit for predicting the association between RD and firm characteristics on non-listed banks. Firm characteristics explained RD by 2.8%, meanwhile 97.2% of RD was explained by other factors.

This research has limitations due to very little literature discussed earnings reinvestment and this study just employed annual reports to test the determinant of RD. Collecting data through interviews to stakeholders is recommended in order to get the reason why the manager disclose their report. To examine the effect of regulations or other factors on RD will be a potentially fruitful area for future researchers.

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