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Understanding Corporate Risk

A Study of Risk Measurement, Disclosure and Governance

Springer

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In the loving memory of
Late Dr. Manoj Kumar

Preface

Risk has been an intriguing phenomenon for both managers and academicians. Much of the ambiguity in the domain may be ascribed to different connotations of risk in different contexts. In view of the debacles such as Enron and Satyam (some years back), and global financial crisis, the concept of corporate risk and risk management has been gaining attention not only from investors and corporates but also from policy-makers.

The present monograph presents a research work relating to risk measurement, disclosure and governance. For the purpose, well-established research techniques, namely expert opinion, diff-GMM regression, nonparametric tests like Kruskal–Wallis test and Mann–Whitney U test, have been used. Besides these techniques, a survey has been administered among top finance personnel of sample companies. Further, the results have been corroborated by the use of a practice-oriented comparative case study.

In operational terms, an attempt has been made to develop a risk index (based on nine major risks, namely market risk, accounting risk, competition risk, contingency risk, credit risk, foreign exchange risk, liquidity risk, operating risk and solvency risk). In addition, the relationship between risk levels and accounting returns has also been examined. Further, a risk disclosure index (based on 69 risk-related items and covering three semantic attributes, namely nature of disclosure (qualitative/quantitative), time orientation (backward-looking/forward-looking/both), tone of disclosure (neutral/positive/negative/both positive and negative)); and a risk governance index (based on board size, proportion of women directors, proportion of non-executive directors, proportion of independent directors, CEO duality, executive/non-executive status of chairman, chief risk officer (CRO), whistle-blower policy, risk management committee, compulsory committees and voluntary committees) have also been developed. Moreover, the relationships among the three indices have also been examined. For the purpose, difference generalised method of moments (diff-GMM) regression has been used.

The notable findings of the secondary data are that the sample Indian firms, on an average, have ‘moderate risk’ levels. These findings are supplemented with the evidence of satisfactory return on assets and return on equity for the sample companies. Further, as the risk index is a normative framework, recommendatory in nature, the evidence of negative risk–return relationship (i.e., higher the risk, lower the returns) provides support for the methodology used in the construction of the risk index.

On the one hand, the sample companies exhibit extremely low scores on risk disclosure index, indicating a lack of transparency regarding the risks and their impacts. On the other hand, the sample companies have sound risk governance structures. But, these could be further strengthened with collaborative efforts of corporates and regulatory bodies.

Though no significant relationship could be found between risk levels and quality of governance structure, risk disclosures appear to be positively influenced by both the risk levels and the quality of governance structure. It is noteworthy that risk governance index acts as a moderating variable, influencing the relationship between risk disclosure index and risk index.

The survey findings indicate that the sample firms consider risk as something with a positive as well as negative potential. Most firms seem to undertake risk management activities in order to protect firm value. Further, the majority of companies have an internal manual for risk management policies and carry a continuous review of techniques used in risk management. It may be noted that companies that seem to be in favour of voluntary risk reporting (in annual reports) tend to have higher risk levels. In addition, the chief finance officer emerges as the most widely accepted authority on risk. It may further be noted that the results of secondary data analysis and survey analysis have been corroborated by the results of a case study (two cases) analysis. The findings of the cases studied provide credence to the methodology used in the construction of risk index, disclosure index and governance index.

Based on the findings of the research, the following recommendations have been made: (i) policy-makers should take initiatives to prescribe a risk index type normative framework for non-financial companies; to help them maintain theoretically tenable risk levels; to enhance transparency and improve communication between companies and stakeholders; and to make risk disclosures mandatory; non-compliance with certain mandatory provisions, such as appointment of woman director, needs to be dealt with swiftly and strictly. (ii) Managers should avoid excessive risk taking as higher risk does not always translate into higher return; they should focus on increasing transparency, improving communication with stakeholders and reducing information asymmetry to garner investor confidence.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
ANOVA	Analysis of variance
BCBS	Basel Committee on Banking Supervision
BOD	Board of directors
BOP	Beginning of period
CAPM	Capital asset pricing model
CCR	Contingency coverage ratio
CEO	Chief executive officer
CFO	Chief financial officer
CI	Composite indicator
CICA	Certified Internal Control Auditors
COO	Chief operating officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CRO	Chief risk officer
DOL	Degree of operating leverage
EBIT	Earnings before interest and taxes
EOP	End of period
ERM	Enterprise risk management
ESOP	Employee stock option plan
EWRM	Enterprise-wide risk management
FASB	Financial Accounting Standards Board
FDI	Foreign direct investment
FMCG	Fast-moving consumer goods
FSB	Financial Stability Board
GARP	Global Association of Risk Professionals
GIM	Gompers–Ishii–Metrick
GMM	Generalised method of moments
HR	Human resources
IASB	International Accounting Standard Board

IATR	Inverse of acid-test ratio
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants of India
ICSI	Institute of Company Secretaries of India
ICT	Information and communication technology
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IRGC	International Risk Governance Council
IRRC	Investor Responsibility Research Center
MD	Managing director
MD&A	Management discussion and analysis
MDI	Modified defensive interval
MMTC	Metals and Minerals Trading Corporation of India
NSE	National Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary least squares
PoF	Proportion of females
PoID	Proportion of independent directors
PoNED	Proportion of non-executive directors
PSU	Public sector undertaking
RDI	Risk disclosure index
RGI	Risk governance index
RI	Risk index
RMC	Risk Management Committee
ROA	Return on assets
ROE	Return on equity
SEBI	Securities and Exchange Board of India
SEC	Securities Exchange Commission
SRM	Spectral risk measures
SWOT	Strengths, weaknesses, opportunities and threats
TD/E	Total debt/equity
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
VaR	Value at risk
WTD	Whole-time director

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