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The Incidence of IFRS 7 on Financial Reporting A Meta-Analysis

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ABSTRACT
A better comprehension of the financial reporting is possible by placing the role of risk disclosures in its IFRS 7 (International Financial Reporting Standards) framework. This paper provides a meta-analysis of the risk disclosures under IFRS 7 Financial Instruments: Disclosures and its role in the quality of financial reporting. Accounting figures are frequently used by shareholders to monitor whether managers have fulfilled their contractual obligations and to restrict discretionary managerial power to promote personal interests. In a jurisdiction, there is an essential element for the development of an efficient corporation, namely a transparent capital market and the overall development of the economy. The corporate disclosure was examined by researchers to provide meaningful information about the annual reports. By investigating the previous specialized literature, the findings show that the financial disclosure requirements represent a consistent requisite in the transparency level of financial reporting under IFRS. There is some evidence in the prior literature which argues the insignificance of risk disclosures. At the same time, some researchers are neutral concerning the role of risk disclosures on financial reporting under IFRS. To sum up, the significant information of the disclosures, from the annual reports, represent a useful requisite for a transparent capital market of the world.

KEY WORDS: *IFRS 7, financial reporting, disclosures, risk, globalisation.*

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I. INTRODUCTION

Global reporting has undergone significant changes over the last decade. A major change was brought about by the adoption of IFRS (Hopper et al., 2017). In 2000, Leutz and Verrecchia analyzed the reduction of risk and cost of capital as direct effects of international standards. IFRS has also facilitated financial investment and, at the same time, amplified the growth of the global economy (Street and Bryant, 2000, Pacter, 2001, Pickard, 2007, Peng and Bewley, 2010, El-Helaly et al., 2020). Statistics show that the number of countries adopting IFRS is growing (IFRS, 2020), because financial reporting involves a number of advantages, namely: IFRS increases the level of international investment and the ability of foreign investors to make economic decisions significantly reduces managerial discretion. In continental Europe, the accounting system has allowed the manipulation of results accounting, efficient reflection of financial gains/losses (Berglund & Eshleman, 2019) given that the main ability of investors is to comply with important decisions, eliminating any confusion considering measuring entity performance, reducing costs on preparing accounting information, allocating financial resources more efficiently, increasing the comparability of financial statements over time, so that the benefits of adopting IFRS outweigh the fees for implementing the real paradigm, increasing the commitment of managers as increased valuation, use of certain recognition/measurement criteria that affect the economic reality, information materialized in accounting notes and free access to the skills specific to accounting standardization (Lisic et al., 2019). In this respect, the accounting rules prevail over the analysis of transfer pricing, taking into account the need for financial statements (Tache, 2020). SEC (Security Exchange Commission) states that the use of a single set of high-quality accounting standards accepted globally by issuers will help investors to understand investment opportunities outside the United States more clearly and with greater comparability than if those issuers would have disclosed its financial results in accordance with a variety of national accounting standards and would allow issuers to access capital markets around the world at a lower cost.

The economic result of risk reporting is demonstrated by its quality through the cost of equity, which is used by investors in making financial decisions and for determining the value of securities, in terms of the balanced portfolio (King, 2009). The cost of equity is defined as the required return on investment, taking into account potential risks. The quality of disclosures is measured by the disclosure index and the ambiguity of the disclosure.

In this vein, the research provides a meta-analysis of the risk disclosures under IFRS 7 Financial Instruments: Disclosures and its role in the quality of financial reporting. The content of risk disclosures increases public confidence and stakeholder interest, which will lead to better decisions (An et al., 2002; Mnif &

Znazen, 2020), given that an entity's board of directors has a significant influence on the decision-making procedure of the company. This paper is organised as follows. Section 2 represents the core introduction of IFRS 7 Financial Instruments: Disclosures and it comprises the conceptual framework of IFRS and the main types of risk disclosures as the risk exposure and the hedging services. Section 3 covers the risk factors under IFRS, and Section 4 includes consistent framework about the informational transparency under the risk disclosures. Further, Section 5 comprises the effects of financial disclosures in financial reporting under IFRS. Section 6 resumes the general conclusion of the present research.

II. IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES

2.1 Conceptual framework of IFRS 7

The International Accounting Standards Board (IASB) has developed an international financial reporting standard IFRS 7 on the disclosure of financial statements, which replaces IAS 30 *"Disclosures in the financial statements of banks and similar financial institutions*". IFRS 7 requires the disclosure of financial information to determine the nature of financial instruments and the potential risks arising from the financial statements (Giner et al., 2020). Currently, uncertainty has arisen from the benchmark reform, which issued the Interest Rate Reference Reform, adding: IFRS 9 Financial Instruments, IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial instruments. The objective of IFRS 7 is to ensure a high degree of transparency regarding the company's financial statements regarding exposure and risk management. By implementing this standard, internal/external users can evaluate:

-the degree of significance of financial instruments.

-the nature and extent of the risk that may arise from the financial statements during the reporting period.

Based on the Enhanced Disclosure Task Force (EDTF) and the European Securities and Market Authority (ESMA), the disclosure index and analyst forecast are used to measure the ambiguity of an entity's disclosure. The determinants used to increase the quality of risk disclosure are company performance, entity size, governance, controls, country-specific characteristics and cultural characteristics (Elbannan, 2016). Financial reporting under IFRS has led to a very high level of information transparency and disclosure of financial statements. These benefits of IFRS have also been observed in the quality of the audit, with more transparent information being reported and a lower degree of risk. IAS 39 (Financial Instruments: Recognition and Measurement) sets out principles for the recognition and measurement of financial assets, financial liabilities and contracts for the purchase/sale of non-financial items. This standard also prescribes principles for non-recognizable financial instruments and for hedge accounting. The presentation and the disclosure of financial instruments are subject to IAS 32 (Financial Instruments: Presentation) and IFRS 7 Financial Instruments: Disclosures, respectively (IFRS, 2020). The purpose of fair values in accordance with IAS 39 has been predicted to occur in the volatility of accounting figures, in the statement of comprehensive income and financial position (Lins, Servaes and Tamayo, 2011). Managers will implement all possible means, such as hedging, artificial practices or discretionary accumulations, to reduce earnings volatility. Earnings management can be accomplished through methods such as adjusting accruals, increasing reported revenue, recording huge cancellations over time, improving other expense periods, accelerating/delaying revenue/expense recognition, changing revenue over time. another period of time, the classification of income/expenditure in other parts of the overall income situation, affecting the deductions related to the periodic nature of certain elements (Fields, Lys & Vincent, 2001). Regarding the American standard FRS 13 (Derivative financial instruments and other financial instruments: disclosures), companies use hedge accounting, which involves the recording of financial assets and liabilities at fair value. At the same time, IAS 39 requires the disclosure of all financial assets and liabilities, derivative/non-derivative financial instruments in the statement of financial position at fair value.

IAS 32 *"Financial Instruments: Disclosure and Disclosure"* does not require the same information as FRS 13. Barton (2001) and Nan (2010) show that hedging indicates a significantly negative correlation with discretionary accumulations. Pincus and Rajgopal (2003) argue that firms use hedging activity to restrict cash flow volatility, while using discretionary accumulations to manage earnings volatility. In 2004, Huang and Liang point out that revenue management provides information about projected cash flows, which could increase the quality of reported information, while Yang, Chun, and Ramadili (2009) show that effective corporate governance mechanisms should reduce revenue management. In general terms, the common problems with revenue recognition are (i) determining the division of multi-delivery transactions into components and (ii) revenue allocation methods. The distinction in revenue recognition would influence gross increases, profit stage indicators and also gross margins. Elshandidy et al. (2013) and Tahat et al. (2016) state that the narrative disclosure of the firm is an important tool for transmitting risk information to investors. Khlif, Guidara and Hussainey (2016) argue that corporate size, leverage, profitability, and risk factors are positively associated with risk reporting. There are two theories that explain why companies should communicate information about risk: economic theory and political theory. Economic theory is based on maximizing agents' profit and uses agency theory, political cost theory, signaling theory, and proprietary cost theory to expose risk disclosure (Taylor, Tower and Neilson, 2010).

2.2 Types of risk disclosure

2.2.1 Risk exposure

Even though the IASB has shared these types of disclosures, there are users such as equity investors who cannot properly differentiate and link hedging activities to a high degree of risk. At the same time, another survey found that disclosures of financial information under IFRS 7 can be understood as generic without providing specific information (Bean and Irvine, 2015). Entity earnings volatility and analyst forecasting are associated with increased risk (Kothari et al., 2009). Regarding insurance, investors' risk perception is diminished (Rajgopal, 1999). Linsmeier et al. (2002) argue that the level of gains and the reaction of the investor decreases when the sense of risk increases. The minimum level of information disclosed contains a sensitivity investigation, for all existing types of market risk. Together with other types of disclosures, qualitative disclosures must contain the exposure risks of financial instruments together with the objectives, policies and methods of risk management. Regarding the disclosure theory, a lower degree of risk premium is associated with the quality of disclosures of financial information of entities (Botosan, 2006; Healy and Palepu, 2001).

In general terms, textual risk disclosures expose management's assessments of imaginable events and possible exposures to market factors (Kravet and Muslu, 2013). In 2011, Kaplan added: *"How can we quantify risk or develop risk indicators for an event that has not yet taken place and hopefully can never take place?"*. Consequently, there are equal chances that risk disclosures will increase or decrease users' perception of risk (Kim and Verrecchia, 1994). Risk assessment involves the disclosure of private or unfavorable information, and firms tend to prevent it when considering their own careers or their competitors. According to the managerial disclosure, risk exposure is associated with the risk arising from financial instruments and insurance is associated with management who must address contingent risks and uncertainties.

Given the risk costs, the survey conducted by Campbell et al. (2014) report negative information on possible trends in the performance of an entity. At the expense of the entity's risk, the information asymmetry is discovered by the number of words about the risk. The number of risk propositions is related to investors 'assessments of idiosyncratic risk and leads to increased investors' perceptions of risk. They find that increased stock return volatility and dispersed forecasts will increase risk disclosures (Kravet and Muslu, 2013). A review of the literature has documented that predictive dispersions are diminished after risk disclosure (Nichols and Wieland, 2009). This huge difference underscores the contingencies of risk disclosures in the knowledge of investors. In section 10-K, the content of corporate debt influences the reliability and dispersion of the forecast (Lehavy et al., 2011).

Although some researchers notes that the importance of financial reporting has declined over several decades, Balachandran and Mohanram (2011) argue the quality of disclosures of financial information is based on conservatism. However, a minimum degree of conservatism is required by information asymmetry, moral problem, and information subjectivity. Moreover, they point out that entities with a low degree of conservatism disclose other details about future financial statements, even if the risks are questionable and can be verified at all times. Over time, the demand for disclosures from stakeholders has increased and managers are required to provide more financial information (Craswell and Taylor, 1992), even if management has an old self-bias, in disclosing positive information about the company. Financial statements have an impact on all users and managers who may be affected by their own information. The risk arises when the outcome of these disclosures does not appear to be profitable for competitors or investors. In this context, managers will disclose generic information (boilerplate disclosures), in order to avoid negative uncertainties about the company.

2.2.2. Hedging services

Specialized studies (Slovic, 1986) suggest that hedging activity has a background in the literature and the content of risk disclosures remains inconvenient to report (Koonce et al., 2005). Market risk hedging remains a common activity for derivatives, which are mandated by standard regulatory mechanisms. In this regard, changes in market prices that directly affect earnings will always reveal quantitative risks, using hedging activities (SEC, 1997). According to IFRS 7 and FRR 48 (Financial Reporting Statement), quantitative disclosures and analysis format have become mandatory (IASB, 2005). Regarding hedging activity, companies have the possibility to choose quantitative or qualitative disclosure (Shao et al., 2019). The risk from the hedging activity represents the risk issued from the volatility of the price changes, in the share of the gains of an entity. Quantifying risk disclosure means quantifying the income affected by potential changes in the market price. In 2009, an International Swaps and Derivatives Association (ISDA) study found that entities use derivatives to hedge business risk. Hedging risks or risks from hedging activities involve changes in risk expense and hypothetical cash flows, which remain unknown to external users. To the extent that the hedging instrument generates changes in earnings, investors will measure a higher degree of risk for hedging activities than for smaller ones (Fisher and Hawkins, 1993). Previous studies show that hedging decisions are only desired if hedging results are recognized by investors (Koonce et al., 2015).

In general, managers lead to the reporting of qualitative rather than quantitative risk disclosures, due to better management of incentives (Titova, 2020). It seems that managers are less specific in terms of disclosing qualitative risk. In the absence of hedging activities, disclosures of qualitative risks are perceived as less risky than quantitative disclosures. Moreover, the theory of psychology attests to the fact that quantitative information is more prominent than qualitative information in terms of judgment. Disclosure mismatch occurs when the content of the hedging item is disclosed qualitatively, and the content of the hedging instrument is disclosed quantitatively (Viswanathan and Narayanan, 1994) and investor judgment is affected. Due to manager-investor conflicts (Jensen & Meckling, 1976) and information asymmetry, the demand for risk disclosure and financial reporting has increased over time.

The content of risk disclosures increases public confidence and stakeholder interest, which will lead to better decisions (An et al., 2002), given that an entity's board of directors has a significant influence on the decision-making procedure of the company (Michelon & Parbonetti, 2012). The first type of risk reduces information asymmetry faster than the second type of risk, which can monitor the resources, management team and risk content included in the annual report. Risk disclosure is defined as information risk and its impact on an entity's future performance and the essential purpose of the board is to provide strategic support and guidance.

III. RISK FACTOR IN FINANCIAL REPORTING UNDER IFRS

In 1921, Knight defined the known risk as the probability of future results understood. Heinle and Smith (2017) defines the unknown risk as the sum of uncontrollable results being too vague to be summarized by predictions. Investor aversion to unknown risk can change the cost of the asset and the consequences of risk factors (Caskey, 2009). With a number of incentives, managers will reveal good information only to investors, for some specific thresholds, and will tend to hold back the bad news. In this context, the emergence of agency theory and management preferences will lead to information asymmetry. Contrary to this problem, management is invited to disclose all private information, to reduce the asymmetry and potential cost of capital (Healy and Palepu, 2001). In particular, a factor such as litigation risk may argue for the disclosure of bad news (Skinner, 1994). Moreover, the company's management can calculate the time to reveal the news, in order to increase its own subsidy. In this regard, Verrecchia (1990) added that *"information can be retained rationally, because it can be used to capitalize on the human capital of the manager as well as the company."* For annual reports, companies must disclose all types of risks at present, and for quarterly reports, companies must update the risk section with new information.

The types of risks related to Campbell et al., (2014) in pre-disclosure and post-disclosure can be financial, fiscal, legal, systematic and idiosyncratic. Apparently, the IASB needs to find an appropriate level of risk disclosure without compromising the quality of financial information. This seemingly endless issue has created a debate for the literature, not just for the IASB. IFRS 7 includes in the requirements both parts of the disclosures, namely: the qualitative part of the disclosures outlines the objectives and management processes, and the quantitative disclosures describe the content of information about the possibilities in which the entity is exposed to risks established internally with key management personnel. All types of quantitative risks (credit risk, liquidity risk and market risk) must have a management record. The first type of risk (Credit risk) refers to the possibility of failing to fulfill an obligation, causing a financial loss. The minimum information must contain information on financial assets. Liquidity risk is associated with the assessment of the fulfillment of obligations in financial liabilities. The minimum information shall include an analysis of the maturity of financial liabilities and an approach to the management of this type of risk. The last type of risk (market risk) includes currency risk, interest rate risk and other price risk. Risk can occur when the fair value of a financial instrument varies over time.

In the initial public offering (IPO), managers requested the first disclosure of risk factors. The IPO refers to the whole process of offering a type of shares of a private corporation to the general public in a new share issue. The issuance of public shares may allow a company to raise capital from public investors. Starting with this requirement, the SEC was able to expand the content of the annual reports. The most important requirement is to disclose possible material factors that may affect performance in the future, in the 10-K field, in *"Element 1A"* (Filzen, 2015). Regarding risk factor updates, the researchers found that there is a negative relationship between future returns and quarterly risk updates over time. The informational value of the annual risk disclosure increased at the same time as the degree of informativeness for the risk factors decreased.

The *"risk factor"* is represented by section 1A of the 10-K form, where the most significant risk factors are highlighted. The content of the information is included in these disclosures, which highlight the types of potential risk (systematic risk, idiosyncratic risk, information asymmetry and firm value). Systematic risk is a constitutive part of the cost of capital. One survey by Kothari et al. (2009) shows that the negative content of disclosures can increase the cost of capital. Another research shows that incremental disclosure reduces this cost. In this regard, we can mention that the asymmetry of information is lower when the level of disclosure is higher (Easley and O'Hara, 2004). With a low degree of measured value of covariance (entity cash flow and market cash flow) a low cost of equity is maintained, given the exact disclosures (Lambert et al., 2007). More, it is argued the positive relationship between disclosures and investor risk assessment of entities, while reducing information asymmetry. Previous research concludes that negative news will increase earnings volatility and negative disclosures will diminish investor predictions about future cash flow. Another hypothesis maintained was that supply-demand will increase when an entity faces a higher risk, concluding that investors have a higher flow of information (Jayaraman, 2008). This ensures that users incorporate the content of the disclosures into the company's risk assessment. Critics of this type of requirement support the presumption that a disclosed risk has been realized in the financial statements. In 2010, the SEC warned entities to avoid generic information and to be more specific through comment letters process. In this regard, since 2010, SEC has integrated a review for general presentation companies to provide more specific information for all users of financial statements.

The previous literature added significant effects of the SFAS 119 standard on the disclosure of derivative financial instruments and of the FRR 48 standard disclosing financial statements, including exchange rates, interest rates and legal rates (Linsmeier et al., 2002). In addition, SFAS 133 (Accounting for Derivatives and Hedging Activities) replaced SFAS 119 (Disclosure of Derivative Financial Instruments and Fair Value of Financial Instruments) and was amended by SFAS 140 (Accounting for Transfers and Servicing of Financial Assets and Settlement of Liabilities), which supports entities that quantitatively disclose derivative financial instruments and hedging activities. Although the disclosure of the textual risk imposed by these standards is significant, there are parties who question their relevance. Even if quantitative information is specified in the financial statements, critics say that disclosures in the financial statements tend to generalize risk factors. Being a substantial corporate policy, financial reporting is based on the principle of prudence (Mora & Walker, 2015). Covering themselves against all kinds of risks, stakeholders ask for bad news asymmetrically rather than good news (Hsieh, Ma and Novoselov, 2019).

Financial information related to risks is established as a significant part of financial reporting. The purpose of these standards is to build investor confidence (Easly and O'Hara, 2004), while decreasing investor demand (LaFond and Watts, 2008) and to increase stock valuation. Risk reporting reduces the asymmetry of information due to the fact that management has been warned about future risks. Moreover, by disclosing all types of risks, managers can prevent a financial crisis and reduce the agency's costs. In reality, only 49% of disclosures are public and more than half of risk disclosures are not disclosed (Hellman, 2018). In addition, only 6% of disclosures have considerable significance in the usefulness of the decision, regarding the quantity of quotation over quality (IASB, 2009). In 1999, Himmelberg, Hubbard and Palia argued that *"when shareholders are too widespread to monitor managers, corporate assets can be used for the benefit of managers rather than to maximize shareholder wealth"*. Most shareholders have partial access to all financial information, and managers can use much of their private information for their own purposes (LaPorta, 1998). Finally, information asymmetry will falsely inform shareholders of potential risks. In this area, most studies have calculated the number of words that reflect risk. In 2013, Mokhtar and Mellett argued that risk disclosures about financial reporting are a real help in calculating the value of the business. However, there is some evidence such as (Linsley and Shrives, 2006) that argued the insignificance of risk disclosures.

IV. INFORMATIONAL TRANSPARENCY UNDER RISK DISCLOSURES

Accounting figures are frequently used by shareholders to monitor whether managers have fulfilled their contractual obligations and to restrict discretionary managerial power to promote personal interests (Watts and Zimmerman 1979). Adverse selection and moral hazard are the problems that occur in the asymmetry of information. The moral hazard highlights the possibility in which the manager, due to the information asymmetry, reacts to an incentive to act inefficiently. In this case, shareholders are not able to monitor the behavior of the manager but are able to judge the quality of work performed. Healy and Palepu (2011) attest that the need for financial reporting and accounting disclosures stems from information asymmetry and conflicts between stakeholders. The credibility of managerial disclosures is enhanced by audit regulators and capital market intermediaries. A unique feature in financial reporting is that the owner of the company (shareholders, e.g.) does not have full control over the accounting information system. However, the accounting regulations to some extent guide the methods chosen by the manager and the existence of the external audit examines the application of these generally accepted principles, but the manager still decides, based on his own interests, the financial information incorporated in the final reporting.

A reduction in information asymmetry increases the liquidity of the company's stock and reduces the cost of capital. Information asymmetry can be reduced primarily by increasing outreach (Brown, Hillegeist and Lo 2004). The literature shows that the richer information environment of larger companies constrains management skills in managing abnormal accumulations. Moreover, the variety of accounting information reduces the frequency of privileged transactions (Frankel and Li 2004). Naser, Nu seibeh and Al-Hussaini (2003) found that credibility and timeliness are the most important features of useful information. Basing contracts on accounting information calculated in accordance with IFRS helps reduce the cost of contracting by reducing risk. The main objectives of financial reporting into three factors. First, financial reporting provides information for users' business and economic decisions. The second objective of financial reporting is to help investors predict future cash flows. The third objective of financial reporting is to provide information about the company's economic resources, resource claims (obligations) and the effects of transactions and events that may affect the existence of resources and claims on them.

V. THE EFFECTS OF FINANCIAL DISCLOSURES IN FINANCIAL REPORTING

The adoption of IFRS has only led to an increase in the disclosure of financial information and an accelerated decrease in the number of options for commonly used accounting methods. Limiting the number of listed methods required by the adoption of IFRS is a huge advantage, as it can control managerial discretion leading to an increase in earnings. In the same context, a year earlier, Byun & Luttecke (2014) stated that entities have a positive reaction, lacking evidence of information asymmetry and a miscalculation in agency costs. The trend observed by Ibanichuka (2018), in this sense, is that these companies that adopt IFRS tend to record small managerial gains, increasing the transparency of information. It was also observed that, where client entities allow a high discretionary power of the manager, no quality improvement results were seen in the post-IFRS period. This discretionary power has raised many issues over time, not always calculated within legal limits. When calculating the discretion of management, the following must be taken into account: the size of the customer entity, the cash flow affected by operational volatility, sales volatility and the probability of negative gains.

In a jurisdiction, there is an essential element for the development of an efficient corporation, namely a transparent capital market and the overall development of the economy. The corporate disclosure was investigated by researchers to provide meaningful information about the annual reports. The content of the annual reports was divided by Marston and Shrives (1991) into mandatory disclosures, which are required by regulations, and voluntary disclosures that may be introduced, to provide more information. Agency theory has been used as the first reporting theory, which has expanded with stakeholder theory. The third theory, the theory of legitimacy emphasizes the contractual terms to continue the operations of an entity (Brown & Deegan, 1998). The financial crisis leads to the reporting of companies' behavior, showing the applicability of social values (Dube and Maroun, 2017), and voluntary disclosure implies a lower level of cost of capital. The last hypothesis in this field is the theory of signaling, which includes theories of legitimacy and agency, suggesting ways to signal information asymmetry (Kromidha and Li, 2019). However, the effectiveness of a financial reporting system depends largely on a complex system of institutional factors (Tache, 2020).

VI. CONCLUSIONS

The adoption of IFRS has only led to an increase in the disclosure of financial information and an accelerated decrease in the number of options for commonly used accounting methods. Financial analysis is seen as a "snapshot" of the company's value over a period of time, in accordance with accounting standards, which helps in the decision-making process. Financial information related to risks is established as a significant part of financial reporting. By mastering the previous literature concerning the role of risk disclosure in the financial reporting under IFRS, the incidence of disclosures is consistent requested by internal and external users, by increasing the level of transparency of the financial reporting. This paper provides a meta-analysis of the risk disclosures under IFRS 7 Financial Instruments: Disclosures and its role in the quality of financial reporting. Taking into consideration that the information asymmetry will falsely inform shareholders of potential risks, the incidence of disclosures will increase for internal and external users of financial statements. For annual reports, companies must disclose all types of risks at present, and for quarterly reports, companies must update the risk section with new information, by increasing the informational transparency under the risk disclosures.

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