Risk Disclosure and Audit Report Clauses in the Tehran Stock Exchange

1- Manije Ramshe (Corresponding Author) 2- Narges Sarlak
3- Mohammad Javad Zare Bahnamiri 4- Reyhane Mirzaei Neko

INTRODUCTION

After the occurrence of financial scandals and economic crises during the past decades, risk disclosure has been one of the concerns of accounting and professional institutions around the world. While acknowledging the importance of risk disclosure, these financial institutions developed accounting standards and provided a framework for exposure and organization of risk disclosure. The German Accounting Standards Board (GASB) published the first comprehensive risk disclosure reporting standard entitled Risk Reporting in 2001. Risk disclosure is one of the most important types of disclosure for several reasons. First, it conveys the existing and potential risks and uncertainties that companies face during their commercial business (threats to the continuity of the company's activity). In addition, risk disclosure through the reduction of agency problems and information asymmetry will contain important implications regarding investment, financing, and liquidity. Risk disclosure will lead to improved stewardship accountability, investor protection, and better risk management. Researchers believe that the importance of non-financial information disclosure has increased in recent years and risk disclosure is one of the most important types of non-financial information from the perspective of investors. Risk disclosure is one of the most important value communication disclosures. In addition to the existing literature in this area, financial institutions around the world have developed the value connection of risk disclosure. The International Association of Integrated Reporting (2013) states that integrated reporting should include risks and opportunities that affect the company's ability to create value and show how the company deals with them. The concept of risk has been developed from covering only the negative consequences of events to positive and negative consequences, although the literature review shows that researchers pay more attention to the negative aspects of risk than to the positive aspects when studying risk disclosure.

1- Assistant Professor, Department of Accounting, Faculty of Economics and Administrative Sciences, University of Qom, Qom, Iran; m.ramshe@qom.ac.ir
2- Associate Professor, Department of Accounting, Faculty of Economics and Administrative Sciences, University of Qom, Qom, Iran; Sarlak.narges@gmail.com
3- Associate Professor, Department of Accounting, Faculty of Economics and Administrative Sciences, University of Qom, Qom, Iran; Mj.zare@qom.ac.ir
4- Master of Science in Accounting, Faculty of Economics and Administrative Sciences, University of Qom, Qom, Iran; re_neko@yahoo.com

Representation and signaling theories are some of the most important management drivers for risk disclosure. Legitimacy theory is another theory explaining the level of risk disclosure in companies. According to this theory, companies with a higher level of risk disclosure are considered legitimate and with higher social accountability. On the other hand, according to the ownership costs theory, due to the sensitivity of risk information, the ownership costs of risk disclosure are higher than other types of information disclosure. For this reason, managers have little desire to disclose risk information to prevent abuse by competitors. Since risk disclosure text reports are usually optional, management motivations affect their content. In addition, the audit of textual disclosures is usually more difficult than the audit of financial statements because even if the basis of risk disclosure is mandatory, the audit lacks a clear framework for the expected level of disclosure. Audit reports about statements and other financial information are one of the most important tools for ensuring the reliability of information published by companies and increasing the quality of their information. The evidence indicates the effect of auditing on reducing the conflict of agency and the possibility of information asymmetry. Considering that limited research has been done regarding the relationship between risk disclosure and the field of auditing, the present study studies the relationship between risk disclosure and the type of audit report, the number, and types of clauses in the auditor's report.

MATERIALS AND METHODS

The sample contains all companies accepted in the Tehran Stock Exchange during the years 2013 to 2020 that have the following conditions:

1. They should not be in the financial industry contains investment companies, banks, insurance, and leasing.
2. To be able to compare the companies, their financial year should end at the end of March.
3. Company information is available.

Thus, 169 companies were studied in this research.

To test the hypotheses, logistic regression has been used with the control of industry effects. Hosmer-Lemeshow tests and prediction accuracy percentage criteria have been used to check the goodness of fit of the models. Variance Inflation Factor (VIF) was used to detect collinearity. Findings show that independent variables do not have collinearity problems**.**

RESULTS AND DISCUSSION

The first hypothesis examines the relationship between risk disclosure and the possibility of issuing a modified audit report. The test results of this hypothesis are similar with both measures of the number of sentences and the number of paragraphs with risk content. The model is significant at the 95% confidence level. The results of the Hosmer-Lemshow test and the prediction accuracy percentage indicate the goodness of fit and the appropriate power of the model.

The variable coefficient of risk disclosure is negative and significant, which means that as the level of risk disclosure increases, the probability of issuing a modified audit report decreases.

The second hypothesis examines the relationship between risk disclosure and the number of paragraphs in the audit report. The test results of this hypothesis are similar to both measures of risk disclosure. The model is significant at the 95% confidence level. The coefficient of the risk disclosure variable is negative and significant, which means that as the level of risk disclosure increases, the number of clauses in the audit report decreases.

The third to sixth research hypotheses study the relationship between the level of risk disclosure and the probability of issuing an auditor's report containing clauses of the lack of sufficient reserve for performance taxes, the lack of sufficient reserve for suspecting claims, audit confirmations, and the clause of lack of documents. Results show shows that by increasing the level of disclosure based on the number of paragraphs, the probability of issuing an auditor's report containing the clauses of the lack of sufficient reserve for performance taxes, the lack of sufficient reserve for suspecting claims, audit confirmations, and the clause of lack of documents decreases.

Conclusion

The present study studies the relationship between risk disclosure and audit reports. For this purpose, risk disclosure was measured based on the number of sentences and the number of related paragraphs through the method of content analysis of explanatory notes of financial statements, management interpretive reports, and board activity reports. The relationship between the level of risk disclosure and the type of auditor's report, the number and type of clauses in the auditor's report were investigated in the form of separate models. The findings of the research regarding the relationship between risk disclosure and the type of audit report show that with the increase in the level of risk disclosure in financial reports, the probability of issuing an unacceptable audit report decreases. This article is governed by using both measures of risk disclosure. In the second hypothesis of the research, the relationship between risk disclosure and the number of paragraphs in the audit report was examined. The results show that risk disclosure has a significant and negative relationship with the number of paragraphs in the audit report. In this way, by increasing the amount of risk disclosure by company managers in the reports, the number of paragraphs in the audit report decreases. According to agency theory, managers provide relevant information to reduce agency costs and prove performance for the benefit of shareholders and creditors. Providing reliable information about risk by management reduces the problem of information asymmetry. On the other hand, independent auditors, while validating financial reports, play an important supervisory role in solving agency problems. In this way, the findings of the present research regarding the negative relationship between the level of risk disclosure and the possibility of issuing an unacceptable report and the number of paragraphs in the auditor's report can be a confirmation of the agency theory in explaining why risk is disclosed. The research of the researchers shows that no previous study has investigated the effect of risk disclosure in the financial reports of companies on the auditor's report.

The second to sixth hypotheses of the research study the relationship between the level of risk disclosure and the possibility of issuing an auditor's report containing the clause of the lack of sufficient reserve for performance taxes, the lack of sufficient reserve for suspecting claims, audit confirmations, and the clause of lack of documents. The reason for choosing these clauses was their frequency in the examined sample. The findings showed that when the measured number of paragraphs related to risk is used to measure risk disclosure, the probability of issuing a report containing these clauses decreases as the level of risk disclosure increases. This indicates that in companies with a high level of risk disclosure, there is a high probability that receivables will be collected when due and doubtful receivables will not occur. In these companies, sufficient tax reserves are considered in the financial statements in such a way that it will not lead to the adjustment of the auditor's report in this regard.

Keywords: Risk Disclosure, Audit Report Clauses, Agency Theory, Signaling Theory, Legitimacy Theory

JEL Classification: **M42, D22, G30**