Risk Disclosures in Bank’s Annual Report: Bangladesh Perspective

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Abstract

A risky business climate often results in a risky investment climate. To reduce this inherent risk investors demand the financial statements to include information that is relevant in helping to accurately assess the risks and uncertainties concerning a business enterprise’s future cash flows and operating results. A bank is a financial institution that creates credit by lending money to a borrower, thereby creating a corresponding deposit on the bank’s balance sheet. Hence, a bank always faces different types of risks. Thus, the investors look for the ways a bank deals with risk which can be explored from the risk disclosures (RDs) in annual reports. Thus, this study aims at evaluating the level of RDs in the annual reports of the listed banks along with the quality of such reporting in Bangladesh. The sample of the study consists of 15 banks chosen randomly from 31 banks with more than 20 branches during the study period from 2009 to 2013. The study is based on secondary data which are collected from annual reports of the sample banks. An un-weighted dichotomous disclosure index has been prepared by dividing the RD reporting items of the banks in seven categories under the heads of Accounting policies, derivatives hedging, financial and other risks, general risks information, financial instruments, reserves and segment information. From the paper, it is measured that the information disclosure in different areas of risk unsatisfactory. Most of the banks’ RD ranges from 11 to 25 out of total score of 43. The quality of risk reporting is also poor.

Keywords: Risk; Risk Disclosure; Risk Disclosure Index; Quality of Risk Disclosures; Annual Reports; Banks in Bangladesh

1. Introduction

Over the last several years, standards of risk reporting have been shown to be a critical dimension of risk disclosure (RD). A riskier business climate often results in a riskier investment climate. To reduce this inherent risk investors demand that financial statements to include information that is relevant in helping to accurately assess the risks and uncertainties concerning a business enterprise’s future cash flows and operating results. It is widely accepted that risk reporting results in both greater transparency and heightened investors’ confidence with benefits to the market performance of the firm (Linsely and Shrives, 2006).

A bank is a financial institution that creates credit by lending money to a borrower, thereby creating a corresponding deposit on the bank’s balance sheet. Lending activities can be performed either directly or indirectly through capital markets. Due to their importance in the financial system and influence on national economies, banks are highly regulated in most countries. Most nations have institutionalized a system known as fractional reserve banking under which banks hold liquid assets equal to only a portion of their current liabilities. In addition to other regulations intended to ensure liquidity, banks are generally subject to minimum capital requirements based on an international set of capital standards, known as the Basel Accords.
Banks are important because they provide many services you could not get without. Without banks, no one would be able to get loans; no one would be able to make interest on their saved money. People would have to walk around paranoid because they are always carrying cash that could be stolen. If we left money at our house, it could get stolen or damaged. There are many reasons to like banks.

Risks are of different types and originate from different situations. We have liquidity risk, sovereign risk, insurance risk, business risk, default risk, etc. Various risks originate due to the uncertainty arising out of various factors that influence an investment or a situation.

At the bank level, the risks are controlled by having rules, systems, and processes that enable prudent banking and that are difficult to circumvent. These rules, systems, and processes can be at the branch level, the regional or zone level, and the top management level.

Thus, the investors look for risk of bank and the way it deals with risk which is disclosed in annual reports. Hence, the study aims at evaluating RDs in annual reports of the banks in Bangladesh both in terms of quality and quantity.

2. Literature Review

The voluntary RD debate in the UK started in 1997 when the Institute of Chartered Accountants in England and Wales (ICAEW) released a discussion paper entitled “financial reporting of risk-proposals for a statement of business risk (Linsley and Lawrance, 2007).” The ICAEW sought to address the issue that current RDs were often incomplete and did not give a clear overall picture of the risks that businesses faced. The paper primarily proposed that a statement of risk should be included in the annual report that identified and prioritized key risks described the risks managements of these risks and also detailed how the risks were measured. The paper also put forward the idea that disclosures should not only focus on past events but should also be “forward-looking in its perspective” (ICAEW 1998).

The Basel Committee on Banking Supervision has also released a paper that sought to address the importance of transparency and disclosures specifically in the banking sector (Basel 2001). The committee saw transparency as stemming from good disclosure and if this existed than the market would create a mechanism whereby banks that who have a subpar risk profile are automatically sanctioned (Linsley and Shrives, 2006). Later papers issued by the Basel Committee (2004) have also sought to encourage banks to increase disclosure and to do so in more detail.

Linsley and Lawrance (2007) however noted that the potential costs of improved RD were substantial and as such the professional bodies call for improved voluntary disclosure have been largely unsuccessful. Schrand and Elliot (1998) echoed this statement by concluding that because of a lack of evidence regarding the connection between disclosure levels and cost of capital there are no incentives for “voluntary disclosure about risk.”

Another major concern regarded the professional bodies request for “forward-looking disclosures.” Linsely highlighted the fact that directors were reluctant to publish this information that it is “inherently unreliable” and could open the door to legal action from investors who acted on it (Linsley and Shrives 2006).

Skinner (1994) outlined the fact that firms discloses both good and bad news supports the selection of a modernist view of the concept of risk for the study. Skinner (1994) states that managers who fail to disclose bad news in a timely manner may incur reputational costs, and this is reaffirmed by Deegan and Gordan (1996) who argued that not disclosing bad news will lead to suspicion from investors that managers are hiding something.

Given the increased interest in RD, active voluntary disclosure debate and the connection among disclosure vehicles an evaluation of risk reporting both in terms of quantity and quality is essential. Thus, this study aims at measuring the risk reporting of banks in Bangladesh.
3. Methodology of the Study

3.1. Data type and source

The study is based on secondary data which are collected from annual reports of the sample banks and related publications and from the website of the banks.

3.2. Population and sample

There were 39 nongovernment commercial banks in Bangladesh during the study period of 2009 to 2013 (Bangladesh Bank Stability Report 2013). Among the commercial banks, 30 were private commercial banks and 9 were foreign commercial banks. Among the banks, 31 banks have more than 20 branches which consists of the population of the study. From the population, the following 15 sample banks have been taken randomly:

- AB Bank Limited (ABL)
- AL-Arafah Islami Bank Limited (AIBL)
- BRAC Bank Limited
- City Bank Limited (CBL)
- Dhaka Bank Limited (DBL)
- Dutch Bangla Bank Limited (DBBL)
- First Security Islami Bank Limited (FSIBL)
- Islami Bank Bangladesh Limited (IBBL)
- Mutual Trust Bank Limited (MTBL)
- Prime Bank Limited (PBL)
- Shahjalal Islamic Bank Limited (SJIBL)
- Social Islamic Bank Limited (SIBL)
- Southeast Bank Limited (SEBL)
- Standard Chartered Bank Limited (SBL)
- United Commercial Bank Limited (UCBL).

3.3. Method of data collection

An un-weighted disclosure index has been prepared by dividing the RD reporting activities of the banks in seven categories named, (a) accounting policies, (b) derivatives hedging, (c) financial and other risks, (d) general risks information, (e) financial instruments, (f) reserves, and (g) segment information.

3.4. Preparation of RD index

Following Hassan (2009) we develop a Bank RD (BRD) index that measures both the type and number of instances of BRD. We reviewed the annual reports of all the sample banks for years 2009 to 2013 and took the average to identify the RDs of banks in annual reports. The study has divided BRD into seven majors sectors to identify related disclosures of 43 items. The heads are as follows:

- Accounting policies
- Derivatives hedging
- Financial and other risks
- General risks information
- Financial instruments
- Reserves
- Segment information.
3.5. Hypothesis

To test whether the RD of the sample banks differ significantly, t-test has been conducted with statistical software called SPSS 20. The hypothesis to be tested is,
• $H_0$: Sample banks’ RD does not differ significantly
• $H_1$: There is a significant difference in the RD of the sample banks.

4. Evaluation of RDs of Sample Banks

4.1. RD related to accounting policies

Accounting policies are the specific policies and procedures used by a company to prepare its financial statements. These include any methods, measurement systems, and procedures for presenting disclosures. Accounting policies differ from accounting principles in that the principles are the rules, and the policies are a company’s way of adhering to the rules. Whether there is any risk related to the accounting policy of the bank should be disclosed to understand the financial statements of the bank in a comprehensive manner.

From the (Figure 1) we see that four banks (MTBL, DBL, SIBL, Standard Chartered Bank [SCB]) disclosed highest risk information related to accounting policy with a score of 7 out of 9. Four banks PBL, IBBL, SEBL, CBL, ABL disclosed 6 whereas the other banks disclosed 5 items. The least score in accounting policies is 4 by SJIBL.

4.2. Disclosure of derivatives and hedging risk

Hedging and derivatives are related terms in the financial and investment world. Hedging is an investment strategy and technique to prevent loss and risks in any market situation. It acts like a prevention and preventive measure like insurance. Derivatives are just one of the hedging instruments. In different situations, hedging can either result in profit or a risk loss. Derivatives are tools that contribute in either result. Both concepts are different in nature. Hedging in the form of investment to protect another investment while derivatives come in the form of contracts or agreements between two parties (Figure 2).

Figure 2 shows the BRD score of fifteen banks related to derivatives and hedging. Only four banks PBL, IBBL, FSIBL and AIBL disclosed 1 out of 2 items whereas the other banks have not disclosed any item. Hence, the disclosure is not satisfactory at all.

4.3. Disclosure of financial and another risk

Financial risk refers to the chance a business’s cash flows are not enough to pay creditors and fulfill other financial responsibilities. The level of financial risk, therefore, relates less to the business’s operations themselves and more to the amount of debt a business incurs to finance those operations. The more debt a business owes, the more likely it is to default on its financial obligations. Taking on higher levels of debt or financial liability, therefore, increases a business’s level of financial risk (Figure 3).

The Figure 3 above shows the RD score of fifteen banks in financial and other risks area. Here, SCB disclosed the highest information related with financial risk with a score of 11 out of 12. Two banks, MTBL and DBL scored 10. The least score in this sector is 8 achieved by CBL. Thus, the level of financial RD is satisfactory.

Figure 1: Bank risk disclosures related to accounting policy

Source: Authors’ calculation from annual report
### 4.4. Disclosure of general risk information

General risks disclosure information include concentration of credit risk, equity risk, exchange rate risk, risk related to, customer satisfaction, high competition, natural disaster, communications, outsourcing, reputation, competition, weather conditions, and change in technology (Figure 4).

From figure 4 it appears that under general risk information head, the highest disclosure is 6 out of 12 by three banks called MTBL, SIBL and FSIBL whereas the lowest is 3 by the two banks called AIBL and CBL. Thus, general RD is unsatisfactory.

**Table 1: One-sample t-test**

<table>
<thead>
<tr>
<th>Risk disclosures of banks</th>
<th>t</th>
<th>df</th>
<th>Significant (2-tailed)</th>
<th>Mean difference</th>
<th>95% confidence interval of the difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total disclosure scores of bank</td>
<td>0.007</td>
<td>14</td>
<td>0.994</td>
<td>0.00333</td>
<td>-0.9664</td>
</tr>
</tbody>
</table>

**Figure 2:** Bank risk disclosures related to derivative and hedging

Source: Authors’ calculation from annual report

**Figure 3:** Bank risk disclosures related to financial risk

Source: Authors’ calculation from annual report
4.5. Risk related to financial instruments

Financial instruments are legal documents that embody monetary value. There are a number of different types of documents that are properly identified as a financial instrument, including cash instruments and derivatives.

Three items called derivatives, face value of instruments and cumulative changes in fair value of such instruments are considered as the related items of financial instruments’ risk (Figure 5).

The Figure 5 shows RD score of fifteen banks in financial instruments. Only four banks called UCBL, DBBL, DBL and SJIBL disclosed only 1 item whereas the other banks have no disclosure in this area. Hence, the disclosure is not satisfactory.

4.6. Disclosure of risk related to reserves

A reserve is profits that have been appropriated for a particular purpose. Reserves are sometimes set up to purchase fixed assets, pay an expected legal settlement, pay bonuses, pay off debt, pay for repairs and maintenance, provision against classified loans and so forth. This is done to keep funds from being used for other purposes, such as paying dividends or buying back shares. The board of directors is authorized to create a reserve (Figure 6).

The Figure 6 shows the RD score of 15 banks in the reserve area. Only one bank has not any disclosure item. The highest reserve related disclosure is 2 out of 3 achieved by 10 banks. Thus, a moderate disclosure is found in this area.

Figure 4: Bank risk disclosures related to general risk information

![Figure 4: Bank risk disclosures related to general risk information](source: Authors’ calculation from annual report)

Figure 5: Bank risk disclosures related to financial instruments

![Figure 5: Bank risk disclosures related to financial instruments](source: Authors’ calculation from annual report)
4.7. Segment information

Segment reporting is the reporting of the operating segments of a company in the disclosures accompanying its financial statements. Segment reporting is intended to give information to investors and creditors regarding the financial results and position of each of the operating units of
a company, which they can use as the basis for decisions related to the company. Since all the banks have branches in different geographical location in the country to deal with different types of clients, two areas of risk-related disclosures have been included here named as geographic and customer connections (Figure 7).

From figure 7 it is evident that under the head of risk related to segment information, the highest score achieved is 2 out of 2 items by SIBL while other banks have only 1 disclosure item except two banks called MTBL and SCB.

4.8. Ranking on the basis of total BRD

The sample banks have been ranked on the basis of their total RD score in accounting policies, derivatives hedging, financial and other risks, general risks information, financial instruments, reserves and segment information as follows (Figure 8).

The Figure 8 shows the total RD score of fifteen sample banks. Banks’ RD scores are limited from 20 to 25. The highest disclosure is 25 out of 45 scored by four banks called MTBL, DBL, IBBL and SCB. The lowest scoring bank is SJIBL and CBL with a score of 20 out of 45 item. The mean disclosure score is 22.93. Thus, RD of banks are not satisfactory.

5. Results of t-test

To test the hypothesis to find whether the level of RDs among the sample banks differ significantly t-test has been conducted, and the results of the test follows (Table 1).

From Table 1, it is seen that the significant value is 0.994 (>0.05). Thus, the null hypothesis is accepted at 5% level of significance which ensures that there is no significant difference in the level of RD of the sample banks in the annual reports.

6. Quality of RDs of the Sample Companies

The sample companies’ RDs seems to follow the same pattern. There is no significant difference among the banks in explaining the type of risk each individual bank is exposed; rather a formal prescribed method of describing risk is followed mostly based on the Basel II requirements. Moreover, there is no change in the RDs over the period of study. Not a single bank is interested to disclose the information which might create a negative impression about its activities. For example, during the study period, the commercial banks in Bangladesh undergone a huge turmoil situation and a good number of financial scams have been created. There is very little and in most of the cases no information is disclosed by the suffering banks about the reason, consequences and remedy of these financial crises. The risk reporting of the sample banks supports the institutional theory which impulses that information disclosure is not just an economic and financial decision when sociopolitical issues are considered (Oliver, 1991). Most of the time banks tend to disclose information mimicking the other leading banks because of tradeoff between cost benefit of disclosing different information as the managers want to make the stakeholders believe that they are following risk management practices according to the industry standard (Dillard et al., 2004).

7. Conclusion and Recommendations

In this paper, we evaluated the level of bank disclosures related to risk and tested whether there are significant differences in the level of RDs in the annual reports by the sample banks. A un-weighted index has been prepared where there are 43 items under 7 heads of BRD. The quality of risk reporting has also been critically analyzed. Based on the results presented in this study, the following conclusions can be made. First, disclosures of different banks in different areas of risk related information are limited from 20 to 25 out of a total score of 43. Four banks MTBL, DBL, IBBL, SCB have the highest BRD score (scored 25 out of 43), whereas PBL and Social Islami Bank Limited disclosed a total of
24 items. On the other hand, the lowest scoring bank is SJIBL and CBL with a score of 20. The average disclosure score is 22.93 which shows a dissatisfactory picture of BRD. Second, the sample banks have shown a better tendency to disclose financial risks than the other areas of RDs. The highest disclosure score in this area is 11 out of 12 scored by SBL. The lowest scoring bank is CBL with a score of 8.

Third, sample banks have the least disclosure in derivatives hedging area. Only four banks called PBL, IBBL, First security Islami bank Limited and Al-Arafah Islami bank Limited disclosed only 1 item out of 2, whereas all other banks have not disclosed any item related with derivatives hedging risk.

Fourth, t-test revealed that there is no significant difference in the level of RDs of the sample banks though the mean disclosure is not satisfactory at all.

Finally, the quality of risk reporting is poor showing a conventional prescribed format of reporting risk with no explanation about significant risk factors. All the banks follow the same standard of RDs which refers a mimicking tendency of them to play safe and secure. They do not expose the real risk experience they are facing and their initiatives to meet the challenges. Thus, the banks risk reporting activities can be explained by institutional theory which refers that the RD is not just an economic decision and it is the result of cost-benefit analysis.

Our results offer important implications for theory and practice. First, this paper explored the level of RD of the commercial banks in Bangladesh which always deals in risky operating environment that is often considered to be invariably opaque. Moreover, such type of research is not done in a large extent here in Bangladesh. Second, the banks are recommended to disclose all relevant risk in their annual reports because the quality of financial reporting depends on relevant disclosures of all materially important items.

Finally, this paper suggests the code of Bangladesh Bank may consist of a rule for enquiring clarification of concealing real risk factors. The investors should be empowered to search for investment relevant risk information. Ignorance of doing so from the banks’ should be penalized by competent authority.

Thus, all banks should disclose all the Risk Associate with them, especially they should disclose derivatives and hedging activities related risk, which is very poor at present, as it can help investors in understanding the risk undertaken by the companies. Real risk exposures, its consequences and remedy should be disclosed for the investors so that they can make appropriate investment decisions.

References


