

AN EXAMINATION OF THE IMPACT OF CULTURE ON IFRS RISK DISCLOSURES FOR FIRMS THAT CROSS-LIST IN THE U.S.

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ABSTRACT

Accounting disclosures is an important factor in the decision making process of users of financial statements. Differences in cultural values across countries may result in different opinions regarding the adequacy or extent of the disclosures on the financial statements. The objective of this study is to examine the effect of culture on IFRS 7 risk disclosures in firms that cross-list in the United States. This paper extends the current literature in the area of culture and IFRS risk disclosure requirements. The study sample consists of 62 international firms that trade in the New York Stock Exchange. A cross-country analysis related to IFRS 7 disclosure level of financial risk was prepared for each firm. Using Hofstede (1983) and Gray's theory (1988), each company and country was divided by cultural area and by a level of secrecy and conservatism scale. A level of risk disclosures was created for each company after considering the extension of the IFRS 7 disclosures in their annual reports. The results suggest that culture (secrecy and conservatism) do not have a significant impact in IFRS 7 disclosure levels. However, other economic and political factors seem to influence risk disclosures in financial statements.

JEL: F2, M16, M40, M41

KEYWORDS: Culture, IFRS 7, Risk Disclosures, Secrecy, Conservatism

INTRODUCTION

International Financial Reporting Standards No.7 (IFRS 7), adopted in 2007, replaced prior standards on risk disclosures. Prior research examines the quality and quantity of financial risk disclosures after the adoption of IFRS 7 (Beretta and Bozzolan, 2004, Bischof, 2009, Miihkin, 2012). Other studies examine the presentation of the risk disclosures in the annual reports (Dobler, Lajili and Zeghal, 2011). Some recent studies consider culture as a factor that will impact the disclosure of risk (Bentley and Franklyn, 2013, Dobler, et al. 2011). Other investigations use Hofstede cultural dimensions (1983) and Gray's framework (1988) to measure cultural effects in many accounting and financial research studies, including disclosures. Douppnik and Riccio (2006) conclude that differences in cultural values across countries could lead to differences in recognition and disclosure decisions. The objective of this paper is to examine the effect of culture on the level of risk disclosures required by IFRS 7. To the best of my knowledge, the cultural effect in the IFRS 7 level of risk disclosures has not been studied in the literature. This study aims to fill that gap. The remainder of the paper is organized as follows. Section 2 describes the relevant literature. Sections 3 and 4 present the methodology and the empirical results obtained. Section 5 presents the conclusions.

LITERATURE REVIEW

Culture

For Geert Hofstede (1983), culture is a collective programming of the mind, hard to change that distinguishes a group of people from others. Hofstede (1983) developed a model to identify the cultural patterns of different countries consisting of four primary dimensions: individualism and collectivism, power distance, uncertainty avoidance and masculinity (or femininity). In 1985, Hofstede added a fifth dimension looking for a long-term alternative (long-term vision). In 2010, he added a sixth dimension to the model, indulgence versus restraint (Hofstede G, Hofstede G.J and Minkov, 2010). According to Hofstede (1983), the individualism and collectivism dimensions deal primarily with the relationship that an individual has with other persons. The power distance dimension refers to how societies function with people who are not equal to each other, either in their physical capacities or their intellectual capabilities. The power distance dimension is related to the magnitude of centralized authority and dictatorial, autocratic leadership. The dimension of uncertainty avoidance focuses on two of the basic facts of life: time travels only one way, and nothing in life is certain. The masculinity/femininity dimension compares the gender dichotomy in civilizations. According to Hofstede (1980, 2001), in a feminine society, there is less division of responsibilities between the sexes. The dimension of Long-term orientation is concerned with nurturing qualities that are geared towards future rewards, especially those of perseverance and thrift (Hofstede, 2001). The sixth dimension (indulgence versus restraint) deals with the gratifications that exist in societies of enjoying life and having fun (Hofstede, et al. 2010).

Other authors have examined the relationship between Hofstede's cultural dimensions and accounting. Gray (1988) developed a theoretical framework that related the initial four dimensions (individualism/collectivism, power distance, uncertainty avoidance and the male and female dimension) with the accounting systems. The researcher used a system of accounting values derived from social values (Hofstede's dimensions). The accounting values were: professionalism versus statutory control, uniformity versus flexibility, conservatism versus optimism and secrecy versus transparency. For Gray (1988), (1) a country that is more individualistic, with reduced uncertainty avoidance and smaller power distance, will be a more professional country, (2) a country where there is more uncertainty avoidance, with more power distance and is less individualistic, increases the probability that it will be a more professional country, (3) a country with increased uncertainty avoidance that is less individualistic and masculine, will be a more conservative country, (4) a country with a high uncertainty avoidance, more power distance, less individualistic and masculine, is more likely to possess the characteristic of secrecy. Douppnik and Perera (2012) mention that Gray developed a framework that uses a scale for the values of secrecy and conservatism. Using that scale, Gray ranked 10 different cultural areas created by Hofstede. A scale of 1 (low secrecy) to 7 (high secrecy) and a scale of 1 (low conservatism) to 5 (high conservatism) was used to rank each cultural area. Douppnik and Riccio (2006) state that Gray's framework predicts that a country that ranks high on the cultural dimension of uncertainty avoidance will rank high on the accounting value of secrecy. That will result in less disclosure of financial information, affecting financial statements comparability.

History of IFRS 7

IFRS 7, Financial Instruments Disclosures, was applicable for all periods commencing on or after January 1, 2007 (Sacho, 2008). IFRS 7 replaced International Accounting Standard (IAS) 30 and substituted the disclosure requirements under IAS 32, Financial Instruments: Presentation, for hedge accounting and fair value measurement. Different to IAS 30, IFRS 7 was not limited to banks. The new standard applies to all entities that have financial instruments. Gebhardt (2012) finds evidence that supports the argument that nonfinancial firms hold substantial amounts of financial assets. The purpose of this new standard is to

improve the usefulness of information for decision making about risk and return for investors and users of financial statements. Bonetti, Mattei and Palmucci (2012) argue that IFRS 7 wanted to reduce investor uncertainty about the effects of a change in risk variables on firms' expected cash flows. IFRS 7 requires an entity to group its financial instruments into classes of similar instruments and to make disclosures by class. Gornik (2006) mentions that an entity that uses IAS 7 must disclose: (1) Information about the significance of financial instruments for an entity's financial position and performance and (2) information about the nature and extent of risks arising from financial instruments, including specified minimum disclosure about credit risk, liquidity risk and market risk.

Credit risk is the risk that a financial asset may become impaired (Sacho, 2008) and is a function of the customer's credit quality (Bischof, 2009). Entities will be required to disclose the following: the maximum exposure to credit risk, credit quality of financial assets that are not overdue or impaired, concentration of credit risk and age of analysis of overdue financial assets that are not impaired (Sacho 2008). Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting the obligations associated with financial liabilities (IFRS 7, 2005). For Bischof (2009), liquidity risk arises from maturity gaps in an entity's current liquidity. IFRS 7 (2005) defines market risk as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risks. Bischof (2009) argues that market risk will also include the disclosure of changes, in for example, equity prices, commodity prices and real estate prices. Sacho (2008) mentions that companies also need to disclose its exposure to other price risks such as stock exchanges prices or indexes. Bischof (2009) explains that operational risk disclosure is not required under IFRS 7.

Effects of Enforcement of Risk Disclosures

Prior research on IFRS 7 suggests that the adoption of IFRS 7 has enhanced the disclosure quality of financial risk. Some authors have studied the quality aspects of financial disclosures. For Beretta and Bozzolan (2004), there is no association between the measures of annual report quantity and annual report disclosure quality. In his study, Bischof (2009) finds that the enforcement of the standard increases the disclosure quality of financial statements and risk reports of Banks in Europe. He also argues that the disclosure quality has shifted from market risk exposures to credit risk exposures. Evaluating the company risk related disclosures in Portugal (a code law country), Oliveira, Lima and Craig (2013) conclude that it is uncertain that recent regulation had been effective in improving the quality of risk information disclosed. However, For Riise and Plenborg (2013), some of the disclosures required by IFRS, including IFRS 7, are highly demanded, but are also among the items most costly to prepare and that users are less satisfied with them. Miihkinen (2012) argues that IFRS firm risk disclosures increases with the new pronouncements in the quantity of risk disclosure with more extensive and more comprehensive information. In their cross cultural study analyzing the attributes of risk disclosures in the manufacturing sector, Dobler, Lajili and Zéghal (2011) conclude that risk disclosures are more common in management reports and on concentrations of financial risk categories. Bonetti, Mattei and Palmucci (2012) conclude that before the IFRS 7 requirement, investors did not approach the firms' exposures to currency risk properly. For Condon (2008), users of financial statements value information about the risk arising from financial instruments to which an entity is exposed, and the techniques used to identify measure, monitor and control these risks.

Factors That Impact Accounting Disclosure

Many studies suggest that some factors may impact accounting disclosures. For Zarsesky (1996), firms operating in the international marketplace are spontaneously disclosing high levels of public information. Jaggi and Low (2000) find that firms from common law countries are associated with higher financial disclosures, compared to firms from code law countries. Hope (2003) results show that both legal origin and culture are important in explaining firm disclosure. Bentley and Franklyn (2013) find that Anglo

cultures are more favorable to disclose risk. Dobler, et al. (2011) concludes that the differences across cultures in risk disclosures can only partly be linked to domestic disclosures regulation. For initial disclosures after the adoption of IFRS 7, Bischof (2009) suggests that it can vary across countries because of the differences in the enforcement and interpretation of IFRS 7 by national banking supervising entities. Cross-listed firms tend to be more transparent in their disclosures. After examining analysts' earnings forecasts, Arping and Sautner (2012) argue that European Union (EU)-firms that cross-list on U.S. exchanges are more transparent. Indeed, disclosure costs can be a determinant factor in the decision to disclose more or less. Frost and Kinney (1996) find that differences in disclosures are related to the fact that some foreign issuers view the cost of meeting written disclosures requirements as exceeding the expected costs of noncompliance. For Admari and Pflleiderer (2000) full voluntary disclosure rarely seems to occur and firms usually do not disclose more than what regulations require. However, as a result of the Sarbanes-Oxley Act of 2002 international firms are required to disclose more.

DATA AND METHODOLOGY

Data and Sample Selection

Since prior studies suggest that culture affects accounting disclosures, the research questions of this study are the following: (1) Does culture have an effect on risk disclosure levels? (2) If culture has an effect on risk disclosure levels, how have disclosures changed after the adoption of IFRS 7 (considering Gray's theory of secrecy and conservatism)? The study sample consists initially of 98 international firms that trade in the New York Stock Exchange as of August 2014. Of those firms, 36 have no available 2012 IFRS Annual Reports. As a result, 62 firms in 18 countries and in 6 regions (Africa, Asia, Europe, Latin American and Caribbean, North America and Oceania) are included in the sample (Table 1).

Table 1: Sample Composition

Total Sample of International Companies Listed in New York Stock Exchange at 2012		98	
Less: Companies with No Available 2012 IFRS Annual Reports		-36	
Final Full Study Sample		62	
Countries used in the full sample	Countries by region used in the full sample		
Argentina	1	Africa	1
Australia	2	Asia	7
Belgium	1	Europe	35
Canada	16	Latin America and Caribbean	1
China	3	North America	16
Denmark	1	Oceania	2
Finland	1	Total	62
France	1		
Germany	3		
Hong Kong	3		
Italy	2		
Japan	1		
Luxemburg	2		
Netherlands	3		
South Africa	1		
Spain	3		
Switzerland	3		
United Kingdom	15		
Total	62		

This table shows the sample of international companies and countries used in the study.

The Mergent online database was used to identify the firms. A cross-country analysis related to IFRS 7 disclosures of financial risk was prepared including the company's name and country of origin, the financial reporting framework used (IFRS, US GAAP or other), their audit firm, and the industry. It also identifies if the company discloses financial risk information in a separate report and/ or in the notes of the financial statements, the name of the report and the description (name) and number of the note, and the type of risk disclosures used by the company. Using Hofstede (1980) and Gray's theory (1988), the country of each

company was classified by a level of secrecy and conservatism (Table 2). According to Gray (1988), the greater the level of secrecy and conservatism, the lower the level of disclosure. On the other hand, the lower the level of secrecy and conservatism, the greater the level of disclosure. A level of risk disclosure, fluctuating from 1 to 3, was created and assigned to each company to consider the extension of the IFRS 7 risk disclosures in their annual reports (Table 3). Each company’s country level of secrecy and conservatism was compared with the level of risk disclosure assigned to analyze their relationship.

Table 2: Distribution of Sample Firms Using Gray’s Theory of Secrecy and Conservatism

Cultural Areas Used Per Gray's Theory	Secrecy*	Conservatism**	Number of Firms Used on Each Cultural Area
	1-7	1-5	
Anglo	1	1	34
Asia colonial	2	3	3
Germanic	6	4	8
More developed Asian	5	5	4
More developed Latin	3	5	8
Nordic	2	2	5
Total			62

This table shows the distribution of the sample firms using the level of secrecy and conservatism according to Gray's theory.

** The ranking of secrecy uses a scale from 1 (low secrecy) to 7 (high secrecy). ** The ranking of conservatism uses a scale from 1 (low conservatism) to 5 (high conservatism).*

Table 3: Level of Risk Disclosures

Levels of Risk Disclosures (Explanation)	Level of Risk Disclosure (Scale)*
1. Notes only	1
2. MDA report or MGT report, and notes	2
3. Risk report only or risk reports and notes	3

** This table presents the level of risk disclosure using a scale with values that fluctuate between 1 (less risk disclosure) to 3 (more risk disclosure).*

Prior research suggests that culture may be correlated with other variables. For that reason, this study includes other control country-related variables to control for economic characteristics that could affect IFRS disclosures for firms that cross list in the United States. Following research done by Hope et al. (2006), this study considers certain economic factors, such as the existence of investor protection mechanisms, because of their probable impact on a country’s decision related to an IFRS disclosure. The investor protection mechanisms used in this study are represented by proxies obtained from *The Global Competitiveness Report for 2021-2013* published by the World Economic Forum (the WEF Report). The factors selected were derived from the twelve pillars used to measure the competitiveness of different countries. The following variables were selected from the Institutional Pillars: protection of minority shareholders’ interests and strength of investor protection. Other control variables used (regulation quality, control of corruption, government effectiveness and political stability) were obtained from the Worldwide Governance Indicators (2012). Legal origin was also included in the model considering Hopes’ (2003) argument that legal origin is a key determinant of international disclosure levels. Consistent with Gray’s Theory, the expectation for this study is that the greater the level of secrecy and conservatism in a country, the lower the IFRS risk disclosures and vice versa. In addition, countries with higher levels of protection of minority interests, strength of investor protection, regulation quality, control of corruption, government effectiveness and political stability) are expected to have more IFRS risk disclosure levels. Based on Hope’s findings (2003), common law countries are expected to have more IFRS risk disclosure levels than code law countries.

Research Design and Empirical Model

The following model (equation 1) was developed to estimate the relationship between Risk Disclosure Levels, Cultural factors, and other Control variables

$$RDL_i = a_0 + b_1Sec + b_2Con + b_3Comm / Code + b_4PMI + b_5SIP + b_6RQ + b_7CC + b_8GE + B_9PS + \varepsilon$$

where RDL_i represents the IFRS risk disclosure level per firm observation, Sec represents the value of secrecy, Con represents conservatism, Comm/Code represents common law and code law, PMI represents protection of minority interests, SIP represents strength of investor protection, RQ represents regulation quality, CC represents control of corruption, GE represents government effectiveness and PS represents political stability. The research expectations were studied using regression analysis for one model. The regression model uses IFRS risk disclosure levels as dependent variables. Gray’s cultural values for secrecy and conservatism and some political-economic values were used independent variables. The following section presents and discusses the results obtained, including the results of the regression analysis and their possible interpretations.

RESULTS AND DISCUSSION

Table 5 shows the results obtained and seem to suggest that the cultural values of secrecy (*Sec*) and conservatism (*Con*) do not have a significant impact on risk disclosure levels. In addition, the control variables of common law and code law (*Comm/Code*), protection of minority interests (*PMI*) and strength of investor protection (*SIP*) were not significant on risk disclosure levels. The results obtained for control of corruption (*CC*) and regulation quality (*RQ*) suggest a significant impact on risk disclosure levels (significant at the .05 level). The aforementioned results seem to support the prior research expectations that higher values for these factors are related to more IFRS 7 risk disclosure levels. However, the results also seem to suggest a significant negative relation between political stability (*PS*) and government effectiveness (*GE*) with risk disclosure levels (significant at the .05 level). The explanatory power of the adjusted R² of the model suggests that a country’s cultural values and other economical-political factors may help to explain risk disclosures levels required by IFRS 7.

Table 5: Regression Analysis Results

	Alpha	Secrecy	Con	Comm/Code	PMI	SIP	PS	CC	GE	RQ
Coefficients		-0.005	0.025	-0.437	-0.012	0.115	-0.92	2,409	-3.593	1.039
p-value	0.003	0.158	0.959	0.392	0.972	0.338	0.001*	0.002*	0.006*	0.045*
Adj. R ²	0.243									

*This table shows the Regression Analysis Results for the relationship between Risk Disclosure Levels, Cultural factor (Secrecy and conservatism), and other Control variables: Comm/Code-Common law/code law, PMI- protection of minority interest, SIP-Strength of investor protection, PS-Political stability, CC- Control of corruption, GE-Government effectiveness and RQ-Regulatory quality). *Significant at the 0.05 level.*

CONCLUDING COMMENTS

Prior research (Jaggi and Low, 2000; Hope, 2003; and Hope et al., 2006, among others) suggests that differences in culture, economic and political factors may influence financial disclosure levels. Bentley and Franklyn (2013) find that Anglo cultures are more favorable for disclosure of risk. The purpose of this study was to explore the impact of culture on IFRS risk disclosure levels. The results obtained seem to suggest that culture (secrecy and conservatism) do not have a significant impact in IFRS disclosure levels. The results may also suggest that disclosures have changed since the adoption of IFRS. However, other economic and political factors seem to influence risk financial disclosures. Countries with higher control of corruption and regulation quality appear to have more IFRS risk disclosure levels. These results partially support the research expectations that countries with higher levels of protection of minority interests, strength of investor protection, regulation quality, control of corruption, government effectiveness and political stability will have increased IFRS risk disclosure levels. Since the principal cultural variables used

in the study were not significant, in contrast with some of the control variables used, future research should consider other methodologies that can measure the impact of cultural factors in IFRS risk disclosure levels. In addition, future research could consider the risk disclosures levels developed for this study and incorporate factors such as the standard industry code (SIC) and the name of the independent auditing firm.

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