

An Investigation of the Impact of Corporate Governance Mechanisms on Level of Corporate Risk Disclosure: Evidence from Kuwait

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ABSTRACT

This study investigated the association between corporate governance mechanisms and corporate risk disclosure (CRD) in the annual reports for a sample of 109 Kuwaiti listed non-financial companies in 2012. The study used a manual content analysis to measure risk disclosure by counting the number of risk-related sentences in annual reports. A multiple regression analysis was used to test the impact of board size, non-executive directors, percentage of family members on board, role duality, and audit committee on CRD. The quantity of risk disclosures in the Kuwaiti companies' annual reports was very limited. The results showed that the larger board size has a positive impact on CRD. However, the findings also indicated the existence of role duality lead to lower risk disclosure. Other corporate governance mechanisms did not explain variation in CRD.

1. Introduction

In recent years, risk management has evolved worldwide to grip variety business operations and activities. As a consequence, there has been a demand for corporate risk disclosure (CRD) by stakeholders to assess the significance of the risk. Prior studies argue that corporate governance and risk disclosure are increasingly interrelated (Collins *et al.*, 2014; Oliveira *et al.*, 2011a; Lajili, 2009). This highlights the importance of interdependence and mutual impacts of corporate governance choice on risk -management strategies and disclosures. Linsley & Shrides (2006, p. 388) defined CRD as *"any opportunity or prospect, or of any hazard, danger, harm, threat, or exposure, that had already impacted/or may impact upon the company, as well as the management of any such opportunity, prospect, hazard, danger, harm, threat or exposure."* In several countries there have been changes in regulation to enforce companies to make more disclosures. However, companies still disclose relevant information voluntarily. Risk disclosure is no exception and recent governance regulations and guidance seem to offer research opportunities to follow companies' responses to these regulations and then examine any changes in disclosure behavior.

The purpose of this study is to investigate the impact of corporate governance mechanisms on corporate risk disclosure in Kuwait. Prior studies investigating the influence of corporate governance mechanisms on risk disclosure are scarce. These studies were mostly in developed countries (Collins *et al.*, 2014; Elzahar & Hussainey, 2012; Beasley *et al.*, 2005). However, this issue was neglected in Middle East countries in general and Kuwait in particular. This study intended to fill this research gap.

Kuwait was a particular focus of this study because of its unique socio-economic context. First, Kuwait is an emerging capital market that adopts an open economic philosophy based on the market economy and liberalization of trade. Second, Kuwaiti government has initiated several far-reaching reforms at the Kuwait Stock Exchange (KSE) to mobilize domestic savings and attract foreign capital investment. These measures include privatization of state corporations through the stock exchange and allowing foreign investors to own shares tax free in the listed companies since 2000. Third, the KSE is becoming an important capital market in the region. It is ranked the second largest market in the Arab world (after Saudi Arabia) in terms of total market capitalization (AMF, 2013). Fourth, compared to other countries with advanced capital markets, the Kuwait accountancy profession is lagging behind in terms of offering professional certificates. Finally, the Kuwait regulatory framework incorporates different legislation that requires the disclosure of risk-related information in the corporations' annual reports. These reasons make investigating CRD an important issue in Kuwait.

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This article is organized in seven sections. After this introduction, section two describes risk disclosure and corporate governance in Kuwait. Section three reviews literature on CRD and corporate governance and describes theories used in the study. Section four discusses hypotheses development. Section five discusses the data collection and research methodology. Section six presents and analyzes the empirical findings. The last section discusses the study conclusions, limitations and future research.

2. Corporate Governance and Risk Disclosure in Kuwait

The Kuwaiti government forms the financial reporting regulation and the corporate governance code. According to these regulations, the main focus of these regulations is to enhance transparency and maintain investors' confidence. The Ministry of Commerce and Industry and the Kuwait Stock market are the only bodies responsible in issuing accounting regulations and corporate governance principles. The most important sources of regulation for companies listed on Kuwait Stock Exchange are Company Law No. 15 of 1960 and its amendments, the Stock Exchange Law of 14/8/1983 and its amendments and the Ministerial Resolution No 18 of 1990 requiring all companies operating in Kuwait to comply with the International Accounting Standards (IASs; currently known as International Financial Reporting Standards – IFRS) beginning from 1 January 1990.²

First, Company Law No. 15 of 1960 and its amendments govern the preparation of financial reports for listed companies. The company law requires companies to maintain records of their operations and the board of directors in each shareholding company to prepare, for the financial year, a balance sheet and a profit and loss statement which must give a "true and fair" view of the company's financial position within three months after the end of the financial year. The law requires that these statements must be audited by at least two registered auditors and submitted to the Ministry of Commerce and Industry. The law also requires companies to distribute their statements to their shareholders. The law, however, does not specify what set of accounting standards must be used by companies in preparing their financial statements.

Second, Ministerial Resolution No. 18 of 1990 was issued to force companies operating in Kuwait to comply with the International Accounting Standards (IASs; currently known as International Financial Reporting Standards – IFRS) beginning from 1 January 1990. Listed companies are required to comply with IFRSs. According to the Resolution, the aim was to improve the level of information disclosure. Since Kuwaiti companies prepare their financial reports in harmony with IASs that include IAS 32, Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement (also known as IFRS 7), financial instruments disclosure became obligatory after January 2007. Other standards such as segment reporting and contingencies (Alfredson *et al.*, 2007) require the Kuwaiti companies to disclose risk information. These standards focused mainly on financial risks exposures and management policies. Nevertheless, the questions of "whether the level of CRD varies among Kuwaiti companies?" and "whether the corporate-specific characteristics determine level of CRD?" remained to be answered in this study.

The Ministry issued a number of corporate governance principles in the company law No. 15 of 1960 and the KSE law issued an Amiri Decree of 14/8/1983. There are 12 provisions concerning corporate governance practices in the company law. Specifically, these provisions concerns the election of boards of directors and their term in office, the vacancy of a board member, the minimum number of meetings of a board of directors in the financial year, and the liability of the board of directors to the company and shareholders. The company law stipulates a minimum of three directors for each company with no ceiling on the maximum number, and the term of office is not more than three years, renewable.

In terms of board composition, the company law provides for the appointment of one or more executive directors by allowing directors to hold concurrently with the office of director any other office or place in the company, but there is no provision for the balance of executives and non-executive directors. The law is silent for the proportion of family members on the board. In terms of board structure based on duality or otherwise of the chief executive officer's role on the board and in the company itself, the company law does not prevent the appointment of the same individual as chairman of the board of directors and CEO. The law is silent on creating an audit committee or any other committee such as risk committee.

²Recently, due to the intention of the government to become the regional financial center in Middle East, the Ministry of Commerce issued a new company law no. 25 of 2012 and the Capital Market Authority (CMA) was established in 2010. The CMA promulgated for the first time in June 2013 corporate governance code. The discussion of these new laws is out of the scope of this study.

The KSE law is silent on all of the above provisions. The law contains only to corporate governance principles. The law only requires that all members of a company's board of directors inform the stock exchange administration of the number of shares owned by the director within one month from the date of their appointment to the board of directors. However, such information is not published. Only the stock market is informed of it. The law also stipulates that no members of the board of directors of a company may have any direct or indirect interest in contracts and transactions that are concluded with or for the company, unless they have been granted an authorization from the general meeting. In 1999, the KSE issued Law No 2 states that every shareholder who holds more than 5% of the outstanding shares should inform the board of directors, and the directors are required to send this information to KSE.

Finally, the Stock Exchange Law of 14/8/1983 and its amendments set registration conditions that affect CRD. Companies that wish to be listed on the KSE must meet a number of accounting requirements set out by KSE. It requires companies to fully disclose with an appropriate level of transparency certain risk-related information. For example, the capital market registrants have to provide explanatory information that relates to their companies' circumstances and activities to raise investors' *fiduciance*. The KSE requires more detailed requirements that emphasis risk reporting. Specifically, the potential registrants must supply financial statement users with a report from the company's board of directors that includes (1) a statement of the significant events and unexpected circumstances that the company has experienced from its incorporation up to the date of submitting the application for listing; (2) the board of directors' assessment, supported by figures, of the company's performance and achievements compared to the board expectations; and (3) any significant developments affecting the prices of the company's shares such as catastrophes, fires, mergers, the issue of new shares, the discontinuance of a production line, voluntary liquidation or law suits filed or unexpected events against the company will.

The Kuwait Accounting and Auditing Association (KAAA), the only professional body in Kuwait, formed in 1973. The KAAA has no power to regulate the profession or enforce compliance but, recently it provides advices to the government when it is asked to do so. However, its work is still limited to conducting courses in accounting standards and financial statements analysis.

3. Literature Review

Most existing research examines the association between risk disclosure and corporate-specific characteristics in both developed and developing countries (e.g., Beretta & Bozzolan, 2004; Lajili & Zeghal, 2005; Linsley & Shrivs, 2006; Konishi & Mohobbot, 2007; Deumes & Knechel, 2008; Amran *et al.*, 2009; Taylor *et al.*, 2010; Dobler *et al.*, 2011; Mousa & Elamir, 2013). These studies reported that corporate-specific characteristics have an impact on corporate risk disclosure. Prior studies investigating the influence of corporate governance mechanisms on risk disclosure are scarce. Taylor *et al.* (2010) argued that companies with good corporate governance structure are more effective in risk management and disclosure. The first study investigates this issue is the study of Beasley *et al.* (2005) who examines the association between level of risk disclosure and corporate governance mechanisms and other corporate factors for a sample of 123 American and international companies. They used content analysis by counting sentences to measure risk disclosure. Applying multivariate regression analysis, they found that risk disclosure associated positively with non-executive directors and role duality. They also reported that presence of Big Four international audit firms had a positive impact on risk disclosure.

Lajili (2009) attempted to investigate the relationship between corporate governance mechanisms and risk disclosure behavior using a sample of 225 Canadian listed companies in 2002. He used content analysis approach to measure risk disclosure. Multiple regression analysis was applied to test such a relationship. He reported that board size and percentage of non-executive directors on the board were positively associated with risk disclosure. With respect to control variables, he found that company size was associated positively with risk disclosure.

Oliveira *et al.* (2011a) investigated the association between corporate governance and company characteristics and CRD in a sample of companies from Portugal. They used content analysis to measure the extent of risk disclosure. Applying multivariate regression analysis, they reported that non-executive directors, company size, and leverage were positively associated with risk disclosure. Other variables

(existence of independent audit committee and auditor type) were insignificantly associated with the extent of risk disclosure.

Elzahar & Hussainey (2012) investigated the impact of corporate governance characteristics on the extent of risk disclosure in 72 companies in the UK. A content analysis based on counting sentences was used to quantify risk disclosure. They used multiple regression analysis to examine such a relationship. They reported that corporate governance characteristics (board size, non-executive directors, role duality and audit committee) were insignificantly associated with risk disclosure. However, with respect to control variables they reported that company size and industry associated positively with risk disclosure. Other control variables (leverage, liquidity, profitability and cross-listing) were not significant in explaining variations in risk disclosure.

Ismail & Abdul Rahman (2012) attempted to investigate the influence of corporate governance mechanisms on risk disclosure in Malaysia. Their analysis included a sample of 124 companies over three years period, 2006-2008. They reported that risk disclosure was relatively low. They used multiple ordinary least square to test the relationship between corporate governance characteristics and risk disclosure. They found that non-executive directors did not play role in risk disclosure. However, directors' education was positively associated with risk disclosure.

Collins *et al.* (2014) investigated the association between corporate governance mechanisms and level of risk disclosure in South Africa. Multiple regression analysis was used to test the relationship between risk disclosure and corporate governance characteristics as the determinants of risk disclosures. They reported that board size and independent non-executive directors were positively related to the level of risk disclosure. The findings, however, reported that role duality had no relationship with the extent of risk disclosure. They concluded that their results are consistent with relevant theories such as agency and stakeholder theories.

These referenced studies provided evidence that various corporate governance mechanisms affect risk disclosure. These studies used a group of characteristics containing key variables: board size, non-executive directors, audit committee, role duality. The presence of family members on the board was ignored by prior studies although this variable is believed to influence risk disclosure. In addition, none of these studies explored corporate risk disclosure in Kuwait. This study fills this gap.

3.1 Theory

Prior research argued that a joint consideration of disclosure theories should be of great help in explaining a particular phenomenon by providing richer insights into the understanding of corporate disclosure practices; thus disclosure theories should be considered as complementary rather than competing (Carpenter & Feroz, 1992). Similarly, Morris (1987) argued that there is a consistency between both agency theory and signaling theory. He suggests that a combination of them could provide a better prediction of disclosure for more accounting reporting. Therefore, agency and signaling theories were used together in this study to explain the determinants of CRD. According to agency theory, to reduce agency problems, managers have to present relevant information to prove their acting in the interests of the shareholders and debt holders (Healy & Palepu, 2001). The provision of reliable information about risk by the management (the insider who has risk information) to the investors and debt holders (the outsiders who usually do not have that information) will reduce the information asymmetry problem.

Signaling theory explains managers' incentives to disclose more information in the accounting reports (Hughes, 1986; Haniffa & Cooke, 2002). Based on this theory, managers disclose adequate information in the financial reports to convey specific signals to current and potential users. Hughes (1986) argued that this kind of communication is credible to the investors because managers with fraudulent signals will be penalized. In this study, both agency and signaling theories were used to identify the potential drivers of risk information in the annual reports. In developing the research hypotheses, the potential association between specific-corporate characteristics and risk reporting was tested.

The use of multiple theories strengthens the explanations behind CRD practices in an emerging capital market since a single theory may not fully explain these practices, given the specific social and institutional features of that market (Naser *et al.*, 2006; Lundholm & Winkle, 2006; Lopes & Rodrigues, 2007).

4. Hypotheses Development

Based on the results of prior theoretical and empirical research, the special characteristics of corporate governance in Kuwait and data availability, five corporate governance mechanisms were included in the study model. These are: (1) board size, (2) non-executive directors, (3) role duality (4) audit committee, and (5) percentage of family members. There are also five control variables: company size, leverage, profitability, auditor type and industry type.

Board Size

Board of directors plays an important role in the companies' corporate governance. According to agency theory, larger boards incorporate a variety of business expertise leading to more effectiveness in boards' monitoring role (Singh *et al.*, 2004), and therefore more likely to disclose more risk information in annual reports. Based on signaling theory, larger boards may have more incentives to signal their risk management performance to the shareholders. As a result, they are more likely to provide more risk disclosure.

In Kuwait, company law stipulates a minimum of three directors for each company with no ceiling on the maximum number. Therefore, one can expect that larger board is more likely to lead to higher risk disclosure because larger board allows spreading responsibilities leading to more effectiveness in monitoring role and may lead to more risk disclosure. Accordingly, the following hypothesis is formed as follows:

H1: Companies with larger boards are more likely to have a higher extent of CRD.

Previous risk disclosure studies have found mixed results. While Collins *et al.* (2014) and Lajili (2009) reported a positive association between board size and levels of CRD, Beasley *et al.* (2005) and Elzahar & Hussainey (2012) found insignificance results.

Non-Executive Directors on Board

The proportion of non-executive directors to the total number of directors on the board is identified as a significant variable in explaining variation in the level of CRD in prior studies (Elzahar & Hussainey, 2012). According to agency theory, larger proportion of non-executive directors on the boards may enhance the board's effectiveness and help to alleviate the agency problem by monitoring and controlling the opportunistic behavior of management and pursues shareholder interests (Jensen & Meckling, 1976; Rosenstein & Wyatt, 1990). Franks *et al.*, (2001) suggest that non-executive directors are viewed as providing the necessary checks and balances needed to enhance board effectiveness. Forker (1992) found that a higher percentage of non-executive directors on the board was associated with enhanced monitoring of financial disclosure quality and reduce incentives to withhold information. The boards with a higher proportion of non-executive directors are expected to be more effective in performing monitoring role; and thereby affect positively on corporaterisk reporting quality.

In Kuwait, company law left determining the proportion of non-executive directors to the board of directors, as there is no provision for the number of executive and non-executive directors on the board. It can be argued that a board with a higher proportion of non-executive directors is more likely seen to monitor management and to limit the opportunistic behavior of the CEO as they may be less aligned to management. As a consequence, Kuwaiti companies are expected to disclose more CRD to reduce agency costs and to assure shareholders that they are willing to act in accordance to the shareholders' interests. Based on these reasons the following hypothesis is examined:

H2: Companies with a higher proportion of non-executive directors on the board are more likely to have a higher CRD.

Prior risk disclosure studies reported conflicting results. Several studies reported positive relationship between non-executive directors and CRD (Collines *et al.*, 2014; Lajili, 2009; Beasley *et al.*, 2005). However, El-Zahar & Hussainey (2012) and Ismail & Abdul Rahman (2012) reported no such a relationship.

The Percentage of Family Members on Board

The proportion of family member representation might also have an influence on disclosure practice. Based on agency theory, conflicts of interest between management and shareholders are high in a diffused

ownership environment. Thus, companies will disclose more information to reduce agency costs. However, in a more concentrated ownership situation, companies will be more likely to disclose less information because there is more likely little demand for information (Jensen & Meckling, 1976). Equity ownership is represented by directors on the board. Therefore, in countries where families have substantial equity holdings, there is generally little physical separation between those who own and those who manage capital (Nicholls & Ahmed, 1995), because they will elect family members to sit on the boards both as executive and non-executive directors and will have a strong voting power to elect a director, a CEO or a chairman. As such, capital owners do not have to rely extensively on public disclosure to monitor the performance of the company since they have greater access to internal information (Adhikari & Tondkar, 1992). Thus, the higher proportion of family members on the boards, the demand for CRD will be lower and thus the CRD will be lower.

In the case of Kuwait, there are a number of listed companies with substantial family shareholdings that elect family members to sit on the boards both as executive and non-executive directors. Accordingly, companies with higher proportion of family members on the board have little motivation to disclose risk information because the demand for public disclosure is relatively weak. Based on these arguments, it is hypothesized that:

H3: Companies with a higher proportion of family members on the board are more likely to have a lower CRD.

Literature review showed that no study examining the association between the proportion of family members on the board and the level of CRD. However, there are a few studies investigating the impact of family members on board on voluntary disclosure. Ho & Wong (2001) found a negative association between the proportion of family members on the board and the extent of voluntary disclosure in Hong Kong. Other studies used ownership structure to reflect the proportion of family members on the board. For example, Depoers (2000) also found no relationship between ownership structure measured by a proportion of shares held by three largest shareholders and the extent of voluntary disclosure in France.

Role Duality

Role or chief executive officer (CEO) duality refers to a situation in which a single individual serves as both the CEO and chairman of the board. This creates a unified leadership structure. According to agency theory, the combined functions can significantly impair the boards' most important function of monitoring, disciplining and compensating senior managers (Molz, 1988). It also enables the CEO to engage in opportunistic behavior, because of his/her dominance over the board. Such individual who occupied both roles are more likely aligned with management than with shareholders and hence tend to withhold risk information to shareholders. Forker (1992) asserts that a dominant personality in both roles poses a threat to monitoring quality and is detrimental to the quality of disclosure.

In Kuwait, given that company law does not prevent the appointment of the same individual as a chairman of the board of directors and CEO, a number of listed companies are managed by one individual with two positions. As a result, it is expected that companies with CEO duality are more likely to disclose less information in the annual reports because their CEOs may be more likely to maximize their benefits and thus tend to withhold information to shareholders, resulting to less CRD in the annual reports. Accordingly, it is hypothesized that:

H4: Companies which appoint a dominant chief executive officer (CEO) as board chairman are more likely to have a lower CRD.

Prior studies investigating the association between role duality and risk disclosure are scarce and yielded mixed results. While Beasley *et al.* (2005) reported a positive association; Elzahr & Hussaieny (2012) and Collins *et al.* (2014) showed no significant association between role duality and CRD.

The Existence of a Voluntary Audit Committee

The existence of an audit committee has been suggested as a relevant variable in explaining variation in the CRD. The board usually delegates responsibility for the oversight of financial reporting to the audit committee to ensure the quality of financial accounting and disclosure and to enhance the breath of relevance and reliability of annual report (Collier, 1993; DeZoort, 1997). Similarly, Mangena & Pike (2005) reported that the existence of an audit committee involves the necessary of expertise and is associated with

reliable financial reporting, such as, reduced incidence of error, irregularities, and other indicators of unreliable reporting. Moreover, the audit committee is required to review the company's internal control and risk management systems (Oliveira *et al.*, 2011a). According to agency theory, the existence of an audit committee is considered as a monitoring mechanism that attenuating agency costs and improves the quality of information flow in general and CRD in particular between shareholders and managers.

In Kuwait, company law is silent regarding the establishment of an audit committee as it is left to companies' management. However, a number of listed companies in Kuwait have established a voluntary audit committee consisting mainly of non-executive directors. Consequently, one can expect that these directors are more likely inclined to improve the monitoring mechanisms and reduce the amount of risk information withhold to satisfy the needs of shareholders for information. Therefore, it is hypothesized that:

H5: Companies that have a voluntary audit committee are more likely to have a higher CRD.

Previous empirical studies reported no association between the existence of audit committee and CRD (Oliveira *et al.*, 2011a; Elzahar & Hussainey, 2012). This study investigates this issue to explore whether this variable influences CRD in Kuwait given that the establishment of audit committee is voluntary.

Control Variables

Based on the review of CRD literature, it was decided to include five variables as control variables since CRD may be affected by other variables other than corporate governance characteristics. These variables are company size, leverage, profitability, auditor type and industry memberships.

According to agency theory, larger companies need to disclose more information to different users, which leads to a decline in agency costs, and to reduce information asymmetries (Watts and Zimmerman, 1983; Inchausti, 1997). According to signaling theory, larger companies rely on external finance. Hence, they have incentives to disclose more risk information to send a good signal to investors and creditors about their ability to manage risk.

Leverage may also affect the level of CRD. Based on agency theory, agency costs are higher in highly leveraged firms. To reduce these costs, companies need to disclose more information to satisfy the need of creditors (Jensen & Meckling, 1976). Moreover, managers tend to provide more risk management information to send a good signal to debt holders regarding the corporate ability to meet its obligations (Oliveira *et al.*, 2011b).

Agency theory expects that managers of companies with high profitability would tend to provide more risk information in the annual reports to justify their present performance to the shareholders. Applying signaling theory, it could be argued that those companies that are better at risk management will have higher levels of relative profitability and that they would want to signal their superior risk management abilities to the market place via disclosures in the annual report.

Auditor type has been suggested as a factor in explaining variations in disclosure. Jensen & Meckling (1976) argued that large audit firms act as a mechanism to reduce agency costs and exert more of a monitoring role by limiting opportunistic behavior by managers. Chalmers & Godfrey (2004) argued that these larger and well-known auditing firms tend to encourage companies to disclose more risk information to maintain the audit firms' reputation and avoid reputational costs to them. The international Big 4 auditing firms are more likely to pressure their clients to disclose risk information in their annual reports to assure the shareholders about the quantity of risk that their companies face. The signaling literature suggests that there are dual benefits for auditing firms and their clients. The choice of an external auditor can serve as one signal of a company's (or client's) value. For example, Craswell & Taylor (1992) showed that listed companies are more likely to choose a Big Six auditing firm. Such a choice signals to investors that the contents of the annual reports are audited with high quality. Auditing firms may also use the information disclosed by their clients as a way of signaling their own quality (DeAngelo, 1981).

Prior studies have shown that the industry where the company belongs affects its disclosure (Thompson & Zakaria, 2004; Amran *et al.*, 2009; Konishi & Mohobbot, 2007). Companies that operate in different industries are expected to experience different kinds of risk. An industry may be subjected to special regulations due to its nature, thus increasing the risk exposure of companies aligned to it. Lopes

&Rodrigues (2007) argued that according to signaling theory, companies operating in the same industry are more likely to have the same level of risk disclosure to avoid negative appreciation by the market. In addition, signaling theory adds that in certain situations companies adopt certain disclosure practices not necessarily because these practices are effective in communicating information, but to imitate other companies in the same industry. Therefore, they signal to stakeholders that they are adopting the state-of-art disclosure practices similar to other companies in the same industry (Craven & Marston, 1999). The amount of information disclosed by companies may vary according to its industry type. Therefore, it can be argued that CRD varies in accordance to the industry type without specifying a direction to such a relationship.

5. Methodology

This section describes the research method of the study including data sample description, data collection, how the dependent and independent variables are operationalized and the analysis are used to test the hypotheses.

5.1 Sample

The data sample for the study was drawn from companies listed in the KSE because they were the largest companies. The 2012 Companies Guide published by the KSE revealed that on 31 December 2012, 196 companies were listed on the stock exchange. There were 74 financial and insurance companies that were excluded from the study because of materially different types of business operations together with different frameworks for risk disclosure practices according to their regulations (Oliveira *et al.* 2013; Linsley & Shrivess, 2006; Beretta & Bozzolan, 2004). This approach has been followed by a number of previous risk disclosure studies (e.g., Elzahar & Hussainey, 2012; Oliveira *et al.*, 2013; Linsley & Shrivess, 2006; Beretta & Bozzolan, 2004). The remaining sample was 122 non-financial companies. Given the small size of the population, the study aimed to include all non-financial listed companies.

Search engines (www.google.com and www.yahoo.com) were used if web sites addresses were not available from the Companies Guide. Ninety-two companies' annual reports were obtained through accessing companies' web sites. For the remaining 30 companies, the Companies Guide was consulted to obtain the names and addresses of the general managers or chief executive officers. A letter requesting the English version of the 2012 annual reports was addressed to the general manager or chief executive officer of each of the 30 remaining companies. After follow-up letters were sent, 27 companies responded to the request for their annual reports. To prevent undue disturbances caused by fiscal year differences, 6 companies were excluded because of different financial year ends. Similarly, to maintain homogeneity of the sample companies, 4 non-Kuwaiti companies were removed.

The final sample was 109 companies representing 89% of the non-financial companies. This high response rate may reflect the willingness of Kuwaiti companies to supply their annual reports to non-shareholders. The annual reports for year 2012 were chosen because they were the most recent data available on the listed companies at the start of the study and at the time of developing the CRD index.

5.2 Dependent Variable

This study used content analysis to measure the CRD in the annual reports (the dependent variable). This method was selected because the study focuses on the extent or amount and not the quality of the risk disclosures and it is a widely adopted method in corporate disclosure studies. This was consistent with prior risk disclosure studies (Elzahar & Hussainey, 2012; Oliveira *et al.*, 2013; 2011a; Linsley & Shrivess, 2006; Rajab & Handley-Schachler, 2009).

Content analysis is one of research methods used to analyze text data (Krippendorff, 2004). It is a means of categorizing items of text and can be used where a large amount of qualitative data needs analyzing. It involves coding words, phrases and sentences against a particular schema of interest (Bowman, 1984). Content analysis is defined as a research method that uses a set of procedures to make valid inferences from text (Weber, 1990). Such an inferential process varies according to the interest of the investigator. This research technique permits a replicable and valid inference from data based on the context (Krippendorff, 2004). To ensure the replicable manner of inference, a set of interrogation instrument, checklist and decision rules is crafted. It is used to determine the presence of certain words, concepts, themes, phrases, characters or sentences within texts or sets of texts and to quantify this presence in an objective manner.

5.2.1 Risk Disclosure Categories

This study investigated risk disclosure by analyzing the annual reports. This study undertook an extensive review of financial reporting standards, risk disclosure literature, and the Kuwaiti regulatory requirements to develop risk disclosure categories and a list of CRD items (ICAEW, 1997, 2000; Alfredson *et al.*, 2007, p. 212; Beretta & Bozzolan, 2004; Lajili & Zeghal, 2005; Linsley & Shrivess, 2006; Abraham & Cox, 2007; Lopes & Rodrigues, 2007; Robb *et al.*, 2001; Cabedo & Tirado, 2004; Linsley & Lawrence, 2007; Ahmed *et al.*, 2004). The risk disclosure categories and items are outlined in Appendix. The risk disclosures were grouped into seven categories: general risk information; accounting policies; financial instruments; derivative hedging; reserves; segment information with financial and other risks; and commodity risk. These categories were used to calculate the dependent variable: CRD.

5.2.2 Scoring Risk Disclosure Items

This study used "sentences" as a basis for coding and as the recording unit consistent with most studies (Oliveira *et al.*, 2011a; Milne & Adler, 1999; Beretta & Bozzolan, 2004; Rajab & Handley-Schachler, 2009; Lajili & Zeghal, 2005; Linsley & Shrivess, 2006). Milne & Adler (1999) suggested that sentences are more reliable than words and pages in capturing thematic approaches and is deemed more reliable as a coding method. Information in graphs and tables was coded after establishing specific decision rules based on methods used by Linsley & Shrivess (2006) and Beattie & Thomson (2007).

Following Linsley & Shrivess (2006, p. 388), a board definition of risk was adopted to identify risk disclosures. Therefore, sentences were coded as risk disclosures if the reader was informed of "any opportunity or prospect, or of any hazard, danger, harm, threat, or exposure, that had already impacted/or may impact upon the company, as well as the management of any such opportunity, prospect, hazard, danger, harm, threat or exposure." However, disclosures should be explicitly stated and they cannot be implied, so any disclosure was not recorded as a risk disclosure when it was too vague. Any disclosure that was repeated was considered as a risk disclosure sentence each time it was mentioned. Similar to Linsley & Shrivess (2006), each sentence was highlighted if it contained risk information and was ignored if it contained no risk information or was too vague with reference to risk. The irrelevant information was decided to be ignored after being reexamined as suggested by Weber (1990). An aggregated score for risk disclosure for each firm was calculated by counting the number of risk-related sentences in the Kuwaiti annual reports.

Content analysis is inevitably subjective and therefore the coding method needs to be reliable for valid conclusions to be drawn. To ensure reliability of the coded output, this study used the inter-rater or inter-observer method, where two coders were involved in analyzing the same set of material. In this study, the researcher and two others independently operating were the coders. They analyzed five sets of annual reports. The results of the content analysis done by both coders were then correlated to determine the extent of agreement. Scott's Pi measure of inter-rater reliability was 0.80 a level considered acceptable in analysis of corporate report disclosures (Hackston & Milne, 1996).³

³Scott's Pi is the accepted standard for inter-coder reliability that is the widely used measure for the extent to which independent coders evaluate a characteristic of a text and reach the same conclusion. In other words, it measures the extent to which the different judges tend to assign exactly the same rating to each object.

Table 1: Summary of the Dependent and Independent Variables

Variable	Acronym	Proxy
Dependent variable		
Corporate Risk Disclosure	CRD	Total number of sentences related to all categories
Independent variables		
Board size	Bsize	Number of directors on the board of the company
Non-executive directors on the board	NEXC	The proportion of non-executive directors to total number of directors on the board of the company
Family members on the board	Family	The percentage of family members to total number of directors on the board of the company
Role duality	Dual	Dummy variable coded 1 if the chairman is also chief executive officer (CEO) of the company and 0 otherwise
Audit committee	Committee	Dummy variable coded 1 if board audit committee exists and 0 otherwise
Control variable		
Company size	Csize	Natural log of total assets
Leverage	Lever	Total debt/ total assets
Profitability	Profit	Return on equity = net profit/total shareholders' equity
Auditor	Audit	Dummy variable coded 1 = a company audited by local auditor with international affiliation (Big Four), 0 = a company audited by local auditor without international affiliation (non-Big Four)
Industry	Ind	Dummy variable coded 1 = manufacturing company, 0 = otherwise

Source of information for the dependent variable was a company's annual report whereas sources for independent variables were a company's annual report or 2012 companies guide published by the KSE. Data are related to financial year-end.

5.4 Regression Model

This study used the following multiple ordinary least squares (OLS) regression model to examine the relationship between CRD in the annual reports and corporate governance mechanisms and control variables:

$$CRD_j = B_0 + B_1 Bsize_j + B_2 Nexc_j + B_3 Family_j + B_4 Dual_j + B_5 Committee_j + B_6 Csize_j + B_7 Lever_j + B_8 Profit_j + B_9 Audit_j + B_{10} Ind_j + \epsilon_j$$

Where, CRD = the corporate risk disclosure scores for sampled companies, B_0 = the intercept and ϵ_j = the error term. This prior coding helped refine a set of pre-established decision rules which were then applied to the entire sample. Then the researcher performed coding for the entire sample.

5.3 Independent Variables

Data for independent variables were obtained from the annual reports and the 2012 Companies Guide published by KSE. Table 1 summarizes the dependent and independent variables and their proxies.

6.1 Descriptive Statistics

Table 2 shows the descriptive statistics for the corporate risk disclosure (CRD) and its categories. The results indicate that the total sentences of risk disclosure are 1,461 sentences with a mean 19.87. The most common category for risk disclosure is financial and other risks (303 sentences) followed by reserves (282 sentences) with a maximum of 21 and 12 respectively and a minimum of 1 sentence. These results indicate that the sample companies disclosed more financial risks and reserves than other categories. This was because such information was more likely to help readers understand the financial risks facing the companies and the reserves to protect the companies. Therefore, it can be argued that managers of companies disclose this information to signal to both the shareholders and the market that they are able to protect the companies. However, the lowest risk disclosure category is commodity risk (74 sentences) with a maximum of 10 and a minimum of 0. This indicates that companies did not disclose detailed information about pricing risk, tabular presentation and sensitivity analysis.

The findings also show that the sample companies disclosed only 212 sentences of information concerning general risk information. Only one company disclosed 18 sentences and 21 companies disclosed only 1 sentence of general risk information. This low disclosure in general risk information could be related to that managers may not disclose such information as they see this information as not important to users and may not provide users with important information. With respect to accounting policies, although disclosure of accounting policies is mandatory and important for users, the managers of the sample companies disclosed low information (198 sentences). It can be argued that the quantity of risk disclosures for all categories of risks was very limited. For example, the mean for the total risk disclosure is 19.87.

Table 2: Descriptive Statistics for Corporate Risk Disclosure (CRD) and Its Categories

Categories	No. of sentences in all sample companies	Mean	Max	Min
General risk information	212	10.75	18	1
Accounting policy	198	7.59	14	1
Financial instruments	191	4.88	11	0
Derivatives hedging	201	6.01	13	0
Reserves	282	8.23	12	1
Financial and other risks	303	11.91	21	1
Commodity risk	74	2.72	10	0
CRD (Total)	1,461	19.87		

Table 3 shows the descriptive statistics for the independent variables and control variables. The results indicate that there is a wide range of variation within the sample as indicated by the minimum and maximum values. Average board size (Bsize) is 6, with maximum and minimum being 10 and 3, respectively. Jensen & Ruback (1983) suggest that a board size of not more than 7 or 8 directors is reasonable in ensuring effectiveness. The average board size in Kuwait is smaller than board sizes in the US (9) (Beasley *et al.* 2005) and Canada (10) (Lajili, 2009). It is also smaller than Elzahar & Hussainey (2012) who found that mean board size is 11 in the UK. Hassan (2013) documented the mean board size is 7 for UAE listed firms. Samaha *et al.* (2012) found that mean board size is 10 for Egyptian firms.

The mean of the proportion of non-executive directors to total directors on the board is 84%, indicating that a significant number of directors are non-executive directors; however, it is difficult to determine if such directors are independent or not. Beasley *et al.* (2005) reported that the percentage of non-executive directors 87% in American companies. Elzahar & Hussainey (2012) found the proportion of non-executive directors about 68% for UK companies, while Ghazali & Weetman (2006) and Haniffa & Cooke (2002) found the proportion of non-executive director 35% and 45% respectively for Malaysia. Samaha *et al.* (2012) found the proportion of non-executive directors about 55% in Egypt.

With respect to family members, the mean number of family members on boards is 12.5%, which is less than the family proportion in Malaysia. This is consistent with the finding of Ghazali & Weetman (2006) and Haniffa & Cooke (2002). The mean of role duality was 56% which is less than in the UK (95%) (Elzahar & Hussainey, 2012), but higher than in the UAE (18%)(Hassan, 2014). The results also reported that the mean of audit committee was 39% indicating that less than half of the sample did not have audit committee because the law in Kuwait is silent in establishing audit committee. As a result, the existence of audit committee is voluntary in Kuwait.

With regard to control variables, the average company size is 184 million Kuwaiti Dinar in terms of total assets. The mean of leverage is 0.42, with minimum of 0.21 and a maximum of 3.59. Finally, profitability as measured by return on equity has a mean of 0.25, with a maximum value of 0.81 and a minimum value of 0.11.

For the categorical independent variables, there were 69 companies that were audited by a local audit firm affiliated with one of the Big Four and 40 were clients of local audit firm not affiliated with one of the Big Four. For the industry membership, there were 49 manufacturing companies and 60 non-manufacturing companies.

Table 3: Descriptive Statistics for Independent Continuous Variables

	Mean	Minimum	Maximum	SD
Independent variables				
Bsize	5.9	3	10	1.45
Nexc	0.839	0.50	1.00	0.088
Family	0.125	0	0.67	0.196
Dual	0.56	0	1.00	0.498
Committee	0.39	0	1.00	0.477
Csize(KD million)*	184.00	296.45	2610.58	292.00
Lever	0.42	0.21	3.59	0.40
Profit	0.25	0.11	0.81	0.14

*One \$US = 0.285 Kuwaiti Dinar (KD). Table 1 summarizes the independent variables and their proxies.

Ordinary least square (OLS) multiple regression was used to test the interrelations between the various independent and control variables and CRD. Thus, before conducting regression analysis, multicollinearity was tested. One reason for doing this was to indicate whether multicollinearity could cause estimation problems. Table 4 contains a Pearson correlation matrix for the continuous variables. The table shows that the highest correlation was between Bsize and Lever (0.390). Other variables were also correlated, but probably no correlation was sufficient to impair the regression results since the pair-wise correlation coefficients are less than 0.80 (Gujarati, 2003).

Table 4: Pearson Correlation Coefficients Matrix for Continuous Independent variables

	Bsize	Nexc	Family	Csize	Lever
Nexc	0.046				
Family	0.093	0.010			
Csize	0.220*	0.072*	-0.163		
Lever	0.390*	0.031	0.104	-0.113	
Profit	0.021	0.161	0.120*	0.280**	0.017

** Significant at the 0.01 level (two-tailed). * Significant at the 0.05 level (two-tailed).

For definition of the independent variables, see Table 1.

However, another method that is widely used to detect multicollinearity is the Variance Inflation Factor (VIF). This was reported in Table 5. Since VIF did not exceed 10 for any variable in any model, it was concluded that collinearity was not a serious problem (Neter *et al.*, 1983). Further analysis to see whether the multiple regression assumptions were violated was also carried out. The normality, linearity and homoscedasticity assumptions were determined based on the analysis of residuals, plots of the studentized residuals against predicted values, and Q-Q plot. The analysis showed that the untransformed data violated the regression assumptions. Therefore, the data was transformed into normal data using Blom's transformation (Cooke, 1998). The data was re-checked for violation. The problem was then eliminated.

6.2 Analysis and Discussion

This study used multiple ordinary least regression analysis to examine the relationship between CRD and corporate governance mechanisms. The multiple regression results are presented in Table 5. The results showed that *F*-ratio = 6.018, and *p*-value < 0.001. Therefore, the regression model was statically significant. The *R*²(adj.) suggests that approximately 39% of the CRD variation was explained by the independent variables. The *R*² (adj.) was higher than Oliveira *et al.* (2011a) in Portugal (32%) and Elzahar & Hussainey (2012) in the UK, but lower and Collins *et al.*(2014) in South Africa.

Table 5: Regression Results

Independent variable (expected sign)	Risk disclosure Coefficient		VIF
Bsize (+)	0.031	+++	2.581
Nexc (+)	0.083		1.229
Family (-)	-0.040		3.490
Dual (-)	-0.025	+	1.552
Committee (+)	0.011		2.113
Cize (+)	0.065	+++	4.167
Lever (+)	-0.101		1.226
Profit (+)	0.024		1.910
Audit (+)	0.110		1.871
Ind (+/-)	0.012		1.097
Constant	0.142	*	
Adjusted R ²	0.394		
F	6.018		
Prob. (F)	< 0.001		

+++ t test (one-tailed) significant $p < 0.01$; + t test (one-tailed) significant $p < 0.10$, * t test (two-tailed) significant $p < 0.10$. For definition of the independent variables, see Table 1.

The results showed that the CRD was associated positively with board size (Bsize) (P -value < 0.01) and negatively with role duality (Dual) (P -value < 0.10). Therefore, hypotheses H1 and H4 were supported. The findings also showed that the association between CRD and other corporate governance variables (non-executive directors, family members and the existence of audit committee) were insignificant. Therefore, H2, H3 and H5 were rejected.

The results showed that CRD was positively associated with board size (Bsize). This result was consistent with prior studies (Collins *et al.*, 2014; Elzahar & Hussainey, 2012). This finding was also in line with agency and signaling theories. Larger boards incorporate different experiences which lead to more effectiveness in boards' monitoring role and therefore more risk disclosure. Similarly, larger boards have more incentives to signal their risk management performance to the shareholders. Therefore, they disclose more CRD.

The findings also reported that CRD was negatively associated with role duality (Dual). This is consistent with Beasley *et al.* (2005) who reported a positive association between role duality and CRD. A possible interpretation for this result is CEO who occupied both roles tends to withhold risk information to hide his/her opportunistic behavior in order to maximize his/her benefits which it seems to be aligned with management than with shareholders.

With respect to control variables, the findings showed that only company size (Csize) has an impact on risk disclosure. Based on agency theory, larger companies disclose more risk information to satisfy different users, leading to a decline in agency costs, and to reduce information asymmetry. In addition, according to signaling theory, larger companies rely more on external finance. Hence, they have incentives to disclose more risk information to send a good signal to investors and creditors about their ability to manage risk.

7. Summary and Conclusions

This study attempted to investigate the relationship between corporate governance mechanisms and CRD in the annual reports of 109 non-financial companies listed in the KSE in 2012. A manual content analysis was used to measure risk disclosure by counting the number of risk-related sentences in a sample of 109 annual reports. The risk disclosures were grouped into the following seven categories: general risk information; accounting policies; financial instruments; derivative hedging; reserves; segment information and financial and other risks; and commodity risk. A multivariate regression analysis was employed to test the association between risk disclosure and the corporate governance characteristics. The dependent variable was the CRD (total number of risk-related sentences), while the independent variables were a set of corporate governance characteristics and control variables.

The results indicated that the total sentences of risk disclosure were 1,461 sentences with a mean 19.87.

This result means that CRD in Kuwait was very limited. The results of multivariate analysis indicated that board size and role duality influenced CRD. The findings showed that the CRD was associated positively with board size and negatively with role duality. With respect to control variables, only company size was significant and positively associated with CRD. However, the findings also showed that the association between CRD and other corporate governance characteristics (non-executive directors, family members and the existence of audit committee) were insignificant. These results were consistent with a number of prior risk disclosure studies. This study concluded that the findings were also consistent with both agency and signaling theories.

This study made three important contributions. First, it contributed to the understanding of the nature of risk disclosures and the determinants of such disclosures. Second, it also contributed to existing risk reporting literature by being the first to investigate the impact of corporate governance mechanisms on CRD using Kuwaiti companies' annual reports. Third, it also contributed to the literature on the relationship of corporate governance characteristics and risk disclosure practices in developed countries, by testing its application to a developing country like Kuwait.

Several limitations should be noted. First, this study used content analysis to measure risk disclosure through creating risk disclosure scores by simply adding up the number of risk sentences. This approach ignored the usefulness of disclosures that can vary from sentence to sentence. It also ignored the underlying tone of disclosures (good news versus bad news). Future studies may investigate the usefulness of disclosures by determining the good news versus the bad news. Second, this study investigates the influence of corporate governance characteristics on risk disclosure by non-financial companies. Future studies may examine the financial companies to provide a bigger picture of the impact of corporate governance characteristics on risk disclosure in Kuwait. Finally, the findings of the study may not be suitable to generalize to other countries. Such findings could be different from country to country due to industrial composition, economic status and reporting environment and regulations. Therefore, there is a critical need for additional risk reporting research to further close the gaps in the literature. Such studies could help in understanding managers' motivations behind risk disclosure. In spite of the noted limitations, the study did offer insights about risk disclosure in Kuwait.

This study also suggests a number of other avenues for future research. In Kuwait, the Capital Market Authority issued corporate governance code in 2013. Such code has changed the corporate governance mechanisms. Therefore, this study should be replicated in the future to explore any differences between the old and new corporate governance mechanisms and their impact on risk disclosure. In the field of corporate risk disclosure in the Middle East, research could extend this study over a longer period of time or alternatively involve comparative studies with other Arab countries such as the Gulf Co-Operation Council (GCC) member states. Such studies could investigate the changes in corporate risk disclosures across time and compare for potential variation in nations with different social, political and economic systems. This would also help validate the conclusions of this study and overcome the possibility that a small, single-period set may have biased results. This may also help researchers to understand why managers choose to disclose certain parts of risk information and why they withhold other parts. Additional research could be also undertaken to examine the economic consequences of risk reporting in annual reports (e.g., the effect on prices leading earnings, cost of capital, analyst following, and characteristics of analysts' forecasts).

The findings of this study have important implications for the regulators (Capital Market Authority) in Kuwait in their efforts to ensure information adequacy and increasing efficiency of the rapidly developing capital markets. Specifically, the reported results should be useful to accounting and risk regulators by providing information about the inadequacies of CRD in Kuwait and a more complete picture of risk components. The regulators should be also interested in the influence of corporate governance mechanisms on risk disclosure. Such information should be useful to provide the regulators with the best corporate governance mechanisms. Managers may use the findings to match the amount of information in their annual reports with other companies to ensure funds sourcing. The study also provides information for managers to keep investors satisfied about the risk that their companies face. Investors may use the findings for understanding risk disclosure behavior of listed companies in Kuwait. It informs investors about the characteristics of Kuwaiti companies that disclose risk information in their annual reports. Such findings may assist them to diversify their investment portfolios.

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Appendix

Risk Disclosure Categories

General Risk Information

1. Competition in product market
2. Brand name erosion/change/ addition
3. New alliances and joint ventures
4. Relationship to governmentdevelopments plans
5. Customer acquisition processes
6. Recruiting of qualified and skilledprofessional
7. Change in regulations/overseas tax law
8. Events beyond balance sheet
9. Political environment
10. Natural disasters

Accounting Policies

11. Use of estimates/judgments
12. Collateral assets against loans
13. Objectives of provisions/legalconstructive
14. Financial assets impairment
15. Other assets impairment
16. De-recognition of financial assets
17. Risk management
18. Detailed risk management
19. Objective of holding derivatives/instruments
20. Contingent liabilities
21. Contingent assets
22. Inventory lower of cost or market
23. Key sources of estimationuncertainty

Financial Instruments

24. Classifying instruments by risks
25. Principal, stated value, face value
26. Reclassification of instruments
27. Cumulative change in fair value

Derivatives Hedging

28. Hedging description
29. Change in fair value of assets or liability
30. Cash flow hedge

Reserves

31. Statutory
32. Legal
33. Contingency/general Segment information
34. Business major segments
35. Geographical concentration
36. Customer/(asset/liabilities)concentration

Financial and Other Risks

- 37. Operational risk/insurance risk
- 38. Market risk
- 39. Interest rate risk
- 40. Exchange rate risk
- 41. Liquidity risk
- 42. Credit risk

Commodity Risk

- 43. Pricing risk
- 44. Tabular presentation
- 45. Sensitivity analysis