How and why do risk disclosures of our case companies differ?

Corporate Governance - November 2022

Agenda

1. Risk management is a rather current topic
2. What is risk management and why it is reported?
3. Legislation regarding risk reporting
4. Firm-level factors affecting risk reporting and ways to measure risk reporting
5. Case companies
6. Risk reporting in our case companies
7. Findings and analysis

Companies have increasingly faced existential risks realizing during the last years

Russia’s attack on Ukraine

Covid-19

Do investors require more thorough risk management and risk reporting to avoid losses?

Nokia Tires

Finnair

Fortum's Uniper adventures

Reporting of risks and risk management policies reduces agency costs

- Risk = Something bad that may happen
- What is risk management?
  - *The culture, capabilities, and practices, integrated with strategy-setting and its performance, that organizations rely on to manage risk in creating, preserving, and realizing value.* -COSO
- Risk reporting is an effective and mandatory corporate governance tool
  - Decreases agency costs which arise from information asymmetry between management and stakeholders
  - Legislation requires companies to report their risks and risk management policies

Sources: Miihkinen, 2013

Legislation regarding risk reporting consists of hard law and soft law

Hard law (e.g., laws which require)

- Finnish Accounting Act, The Finnish Securities Markets Act
- Companies have to provide description of significant risks
- Publicly traded companies need to provide information on their risk management

Soft law (e.g., codes which recommend)

- Corporate Governance code
- Extensive instructions on risk management in corporate governance code

Factors affecting risk disclosure

Several firm specific factors affect the quality of risk disclosure

- Size
- Age
- Ownership structure
- Profitability

Sources: Miihkinen, 2012; Martikainen et al., 2015; Campbell et al., 2014; Al-Hadi et al., 2017

Risk categories and ways to measure risk disclosure

Risks are divided into five categories

1. Strategic risks
2. Operations risks
3. Financial risks
4. Damage risks
5. Risk Management policies

The quality of risk disclosure can be measured via quantity and coverage

- **Quantity**
  - a proxy for the amount of risk disclosure
  - calculated as a natural logarithm of risk-related words in annual report
- **Coverage**
  - a proxy for the balance of risk disclosure
  - measures firms’ ability to give a balanced description on different risks (1-5)

Sources: Miihkinen, 2012; Martikainen et al., 2015; Campbell et al., 2014; Al-Hadi et al., 2017

All of our case companies operate in retail industry

Kesko

Stockmann

Puuilo

Verkkokauppa.com

Disclosure score of the case companies

	Number of risk-related words	Disclosure score	
		Quantity	Coverage
Kesko	5555	8,62	0,60
Puuilo	3097	8,04	0,78
Stockmann	3938	8,28	0,63
Verkkokauppa.com	2412	7,79	0,54
Average	**3751**	**8,18**	**0,64**

Profitability & Size

	Disclosure score		Profitability (ROA)	Size (Ln(net sales))
	Quantity	Coverage		
Kesko	8,62	0,60	8,08 %	9,33
Puuilo	8,04	0,78	15,83 %	5,60
Stockmann	8,28	0,63	3,37 %	6,80
Verkkokauppa.com	7,79	0,54	8,72 %	6,35
Average	**8,18**	**0,64**	**9,00 %**	**7,02**

Age & Ownership structure

	Disclosure score			Fraction of the
	Quantity	Coverage	Age (years)	biggest shareholder
Kesko	8,62	0,60	82	5,10 %
Puuilo	8,04	0,78	40	5,79 %
Stockmann	8,28	0,63	160	10,50 %
Verkkokauppa.com	7,79	0,54	30	35,41 %
Average	**8,18**	**0,64**	**78**	**14,20 %**

Findings and analysis

Verkkokauppa has the poorest risk disclosures

- The youngest company → usually poorer risk disclosure
- Quite small in comparison to Stockmann or Kesko
- Concentrated ownership – founder/former CEO is the biggest owner → less information asymmetry and less agency costs

Puuilo has the best coverage

- The most profitable and the smallest company → usually poor disclosure
- The least disclosures about financial risks (as the most profitable company)

Stockmann and Kesko have the best quantities

- Large and old firms are associated with better quality risk disclosure
- Both have mediocre scores in terms of coverage
    - Kesko has strong emphasis on risk management policies
    - Stockmann focuses on financial risks as a crisis company

Sources: Miihkinen, 2012

Questions?