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The Effect of Financial Performance, Leverage and Corporate Governance on Corporate Risk Disclosure in Pharmaceutical Industry: Evidence from Indonesia and Malaysia

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Abstract

This research was conducted to examine the factors that influence the practice of corporate risk disclosure. The factors were profitability, leverage, auditor reputation, managerial ownership, and risk committee in the context of pharmaceutical industry in Indonesia and Malaysia. Country was tested as a control variable. Number of the samples collected was 110 firm-observations from year 2015 to 2019. Purposive method of sampling was used to determine the sample. The hypothesis testing using the multiple linear regression indicate that auditor reputation and risk management committee were having a significant positive relationship with risk disclosure index. The insignificant results in profitability, leverage and managerial ownership were believed because the lack of samples number and pool sample from Indonesia and Malaysia which may influence the relationship between independent variables and dependent variable. This study contributes to fill the lack of risk-disclosure reporting issues in developing countries which were not extensively explored.

Keywords: Corporate-Risk-Disclosure, Financial Performance, Leverage, Corporate Governance, Pharmaceutical Industry

Introduction

Financial reporting does not merely provide information about numerical data on financial statement but also non-numerical on non-financial segment. The addition and detailed information that can satisfy stakeholder's interest generally stated on non – financial segment. Corporate risk is one of the disclosures on non – financial segment that has received considerable attention from stakeholders after numerous accounting scandals on big corporates for example cases which happen in the year 2002 such as Enron and WorldCom in United States and Kimia Farma in Indonesia. The financial crisis that happens during 1997 in East Asia and the subprime mortgage in United States during 2008 also one of the reason stakeholders demanded the transparency information disclosure on the financial report (Martínez-Ferrero, Garcia-Sanchez, & Cuadrado-Ballesteros, 2015). It questioned the

effectiveness of corporate risk management and disclosure practice that triggered a regulatory response.

Corporate risk defined as something that can impact the corporate in the future or had already affected the corporate which can be any opportunity or any hazard, danger, exposure (Linsley and Shrives, 2006). Hence, by disclosing risk information, the corporate has tried to be more transparent in providing information to stakeholders. Risk disclosure is highly important to investors, both equity investors and creditors, as these investors may lose money if the corporate in which the investors have invested fails. Furthermore, the risk management and risk disclosure have gained heightened research attention in previous years, however most empirical research have been conducted in developed countries and there is a dearth of risk reporting in emerging countries (Habtoor et al., 2017).

Publishing financial statements annually is mandatory for corporations listed in capital market. According to SFAC No.1 paragraph 50, the information within financial reporting should contain how management used the enterprise's resources. The disclosure of financial statements is used to measure the corporate's accountability to the stakeholders and for making investment, credit decisions or other financial decisions.

Corporate risk is defined as condition that is able to impact corporations in the future or had already affected the corporation which can be any opportunities or any hazards, dangers, exposures (Linsley and Shrives, 2006). Hence, by disclosing risk information, a corporation tried to be more transparent in providing information to stakeholders. So far, risk management and risk disclosure have gained heightened research attentions, however most empirical research conducted in developed countries and there is a dearth in emerging countries (Habtoor et al., 2017). In Indonesia and Malaysia, there are several regulations that maintain corporations to disclose risk information in annual reports, particularly for corporations that listed in the Stock Exchange (IDX and MYX). Both Indonesia and Malaysia follow SFAS 60: Financial Instrument: Disclosure and Decision of Capital Market Supervisory Agency.

This research is intended to examine factors that influence the practice of corporate risk disclosure. The factors are leverage, profitability, auditor reputation, managerial ownership, and risk committee in the context of pharmaceutical industry in Indonesia and Malaysia. Country was involved as a control variable. Pharmaceutical industry was chosen because it includes drug and food companies that have a big responsibility to society so that they are expected to relate to the risk disclosures. Besides, Mazumder and Hossain (2018) mentioned that pharmaceutical industry is frequently facing challenges from internal and external parties; such as lawsuits risks, regulations and inquiry to comply with strict standards, lack of skilled manpower, and swirls of disruptive technology to continuously make product innovations and some advancements in R & D.

This study was among the few that explored risk disclosure in developing countries. Some previous studies observed that this topic mostly conducted in developed economic environments such as UK, Canada, Japan, Singapore and Australia (Demir & Min, 2019). Results of this study contribute to fill the lack of risk-disclosure reporting issues in developing countries.

Literature Review

Corporate governance takes a vital role in supporting corporates in enhance accountability, transparency, and explication of risk disclosure. Corporate governance defines as “the system of checks and balances, both internal and external to corporates, which ensures that corporates discharge their accountability to all stakeholders and act in a socially responsible way in all areas of their business activities” (Solomon & Solomon, 2004 cited in Al-maghzom, Hussainey, & Aly, 2016). Corporate risk disclosure itself is part of good corporate governance practice (Wardhana & Cahyonowati, 2013). Corporate needs to disclose their risk management to show the practice of corporate governance. In practice, the corporate also must explain about the risks of the corporate that arise along with the actions to manage the calculated risks. There are numerous studies that concerning the influence of corporate governance in the practice of corporate risk disclosure.

Achmad, Faisal, & Oktarina (2017) researched about factors influencing voluntary corporate risk disclosure practices by Indonesian corporates. The result showed that the independent board commissioners, managerial ownerships, and institutional ownerships have no relations to the practice of risk disclosure in Indonesian corporates. It is contrary to the research conducted by Sultisyaningsih & Gunawan (2016) which found there is positive significant relation between managerial ownership and risk management disclosure. Habtoor et al., (2017) found that auditor reputation has positive relation to the extent of risk disclosure. Yet, research conducted by Kumalasari & Anisyakurlillah (2014) found there were no effect between auditor reputation and the extent of risk management disclosure.

In addition, the existence of risk management committee can help corporate to manage their risk better and enhance the practice of corporate risk disclosure. Risk management committee itself is responsible to monitoring the risk strategies, policies and risk tolerance level as well as reviewing the sufficiency of risk management policies (Kallamu, 2015). The study conducted by Al-hadi, Hasan, & Habib (2016) found that there is positive relation between the size of risk committee and market risk disclosure. The finding on this study provides evidence that the existence and size of risk committee may be used as a channel to improve disclosure level. While, another research conducted for the corporates listed in Johannesburg Stock Exchange in South Africa by Viljoen, Bruwer, & Enslin (2016) found there was no significant relationship between independent risk committee and level of risk disclosure.

Financial performance is a factor that determine the coverage of disclosure in corporate. Leverage is one of the measurements of financial performance. Leverage of a corporate will affect the number of disclosures made by the corporate, including risk disclosures. High leverage makes corporates face greater risks related to the amount of debt used to finance corporate activities. Foster (as cited in Habtoor et al., 2017) argued that corporate with high leverage tend to have greater motivation to provide more risk disclosure in favour to assure debt holders and creditors the corporate ability to manage risks arise from leverage and fulfil their obligation. A study by Utomo, & Chariri, (2014) found that leverage have positive relation to the practice of risk disclosure. However, Habtoor et al (2017); Dey et al (2018) found negative relation between leverage and risk disclosure.

Agency theory has close relation with corporate governance. This theory is the basis for the corporates to understand the concept of corporate governance. This theory mainly enlightened about the relation between principal (shareholder) and agent (management). Agency theory can explain how the parties involved in the corporate will behave, since essentially between agent and principal have different interests that will lead into agent conflict which could make asymmetry information (Kusumaningtyas & Andayani, 2015). Thus, it is necessary to avoid that conflict by avoid any probability that could trigger the existence of asymmetry information.

Agency theory can be utilized as a basic understanding of risk disclosure practice. The provision of reliable information related to risk by management (internal parties who have risk information) to investors and creditors will reduce asymmetry of problem information. Moreover, with the existence risk disclosure, the quality of financial statement will increase since the information will be more transparent. Agency theory can be utilized as the basic understanding of risk disclosure practice. In this study, Agency theory was used as the basis to understand the concept of corporate governance in corporations.

Hypothesis Development

According to agency theory, corporate's managers with high profit margin tend to provide deeper risk information due to show their shareholders that managers already performed in the best interest of shareholders (Linsley & Shrives, 2006). This proven by studies conducted by Achmad et al., (2017). The first hypothesis is proposed as:

H₁: There is positive influence between profitability and the practice of corporate risk disclosure.

Leverage shows a corporate's ability to fulfil its financial obligations. Corporate with high leverage tend to have greater motivation to provide more risk disclosure in favour to assure debt holders and creditors regarding the corporate ability to manage risks arise from debt and fulfil their obligation. Thus, the leverage level of corporate is a factor that influence to practice of corporate risk disclosure. A study conducted by Utomo & Chariri, (2014) proved that leverage have positive significant effect to risk disclosure. Hence, the second hypothesis stated as

H₂: There is positive influence between leverage and and the practice of corporate risk disclosure.

The agency theory suggests that external auditors have a strong influence in mitigating agency conflicts between managers and investors through enhancing corporate disclosure (Jensen & Meckling, 1976). When corporations are audited by auditor of one Big 4 audit firm, the corporation could enhance information disclosure specially risk. The auditor of the Big 4 audit firm will assist the internal auditor to improve the quality of corporate risk assessment and supervision. Thus, risk disclosure can be disclosing in annual report. Previous studies by Dey et al (2018); Habtoor et al (2017) found that auditor reputation had positive relation to the extent of risk disclosure. The third hypothesis is:

H₃: *There is positive influence between auditor reputation and the practice of corporate risk disclosure.*

Achmad et al (2017) stated that companies that have higher managerial ownership composition incline to disclose less information to shareholders. Since the managers has lower encouragements to meet the demands of shareholders through voluntary risk disclosure. A study done by Achmad et al (2017) found that there was negative association between managerial ownership and corporate disclosure. Thus, the fourth hypothesis proposed is:

H₄: *There is negative influence between managerial ownership and the practice of corporate risk disclosure.*

Risk management committee is responsible to monitor the risk strategies, policies and risk tolerance level as well as reviewing the sufficiency of risk management policies (Kallamu, 2015). The formation of risk management committee within a corporate governance may enhance the practice of risk disclosure. In addition, it may help corporate to give a signal regarding the risk, which might be happen in the future. A study by Al-Hadi et al. (2016) got that there was positive significant influence between the size of risk committee on market risk disclosure. The hypothesis is:

H₅: *There is positive influence between the existence of risk committee and the practice of corporate risk disclosure.*

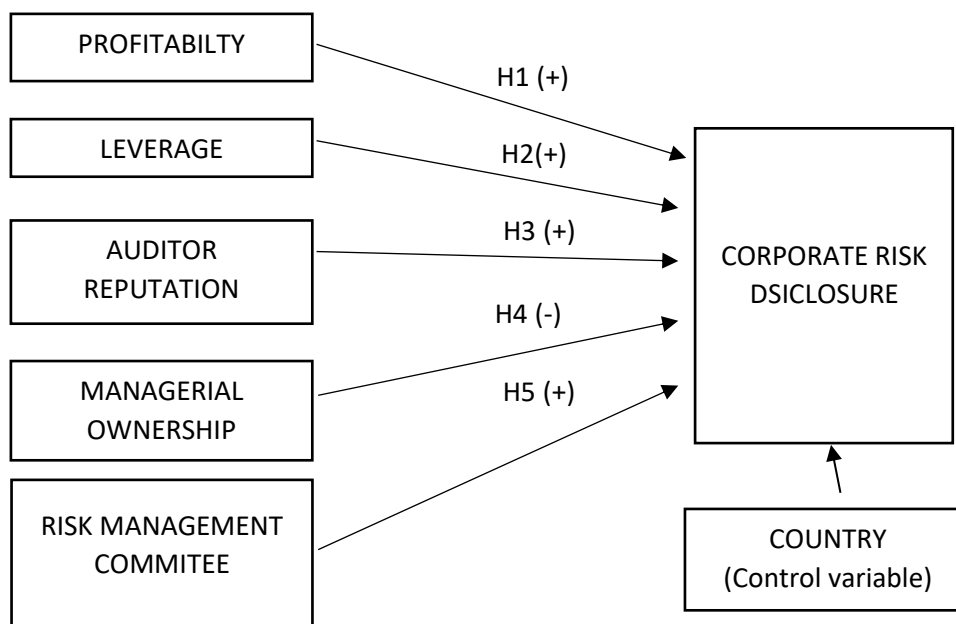


Figure 1: Research Framework

Research Methodology

The population in this study is taken from the annual report of pharmaceutical industry /corporations listed on the Indonesia Stock Exchange and Bursa Malaysia in 2015 – 2019. In the recent years, corporates that are engaged in this field are considered to have experienced a significant decline, so that there are likely a great deal risks experienced and affect the

corporate's risk disclosure report (Wood and Jones, 2016). The pharmaceutical sector is chosen since there is limited research conducted with pharmaceutical sector as subject. Moreover, pharmaceutical corporates are resource management corporates that conduct economic transaction activities with many parties, namely stakeholders (suppliers, creditors, consumers, investors, etc.). Corporates whose economic activities are related to many parties will cause a lot of risks so that they are expected to relate to the risk disclosures carried out by the corporate.

The researcher uses purposive sampling technique to get a sample. The sample has to meet the following criteria:

1. All pharmaceutical corporates are listed in Indonesia Stock Exchange and Bursa Malaysia.
2. The pharmaceutical corporates consistently published their annual report for the period of 2015 – 2019.
3. Corporates that disclose complete information related to this research such as governance corporate, risk management and risk information.

Corporate Risk Disclosure (CRD)

Corporate risk disclosure is the dependent variable that measured by content analysis with disclosure index approach. The score of 1 will be given if a corporation disclosed information as determined in the checklist index and 0 if the corporate did not disclose the information. The items of disclosure check list were adopted from the study of (Achmad, Faisal, & Oktarina (2017), which referred to the Indonesia Financial Services Authority (OJK). There are six categories of risk, including financial risk, operational risk, empowerment risk, information processing and technology risk, integrity risk and strategic risk with total 37 risk details from all categories. The index is formulated as follow:

$$\text{Risk Disclosure Index (RDI)} = \frac{\text{number of items disclosure}}{37}$$

Profitability (PRO)

Profitability is corporate's ability to utilize its resource to generate income (Sjahrial and Purba, 2011). This study picked Net Profit Margin (NPM) to measure the level of profitability. The formula for Net profit margin is as follow:

$$\text{Net Profit Margin (NPM)} = \frac{\text{Net Profit (before tax)}}{\text{Sales}} \times 100$$

Leverage (LEV)

Leverage is determined as a ratio that states the relationship between debt and total equity or corporate's asset (Habtoor et al., 2017). It measures the ability of both long-term debt and short – term debt used to finance a corporate's activities. used to measure the leverage based on (Habtoor et al., 2017) is:

$$\text{Leverage} = \frac{\text{Total Liabilities}}{\text{Total Asset}}$$

Good Corporate Governance (GCG)

GCG is defined by Monks and Forum for Corporate Governance Indonesia (cited in Latupono & Andyani, 2015) as a governance system that explains the relationships of various participants in determining the direction and performance of the corporate. In this study, the corporate governance determined by auditor reputation, managerial ownership, and risk committee.

Auditor Reputation (AR)

According to Jensen & Meckling (1976), external auditors have a strong influence in mitigating agency conflicts between managers and investors through enhancing corporate disclosure. In this study, auditor reputation is indicated by whether a company uses a big accounting firm as the external auditor. The big accounting firm is denoted to the Big Four accounting firms. The dummy variable is used. Companies that use one of the Big 4 Accounting firm get 1 point and 0 for companies that do not.

Managerial ownerships (MO)

According to Weisbach (1988) as cited in Kamardin (2014) managerial ownerships works as direct encouragements for managers to act in line with shareholders' interests. Managerial ownership is the ratio of shares owned by all managers to total shares outstanding (Ruan & Tian, 2011). It is determined:

$$\text{Managerial ownerships} = \frac{\text{Number of Shares Own by Managers}}{\text{Total Outstanding Shares}}$$

Risk Management Committee (RMC)

RMC is an independent committee that responsible for the risk management policies (Kallamu, 2015). Meanwhile, risk committee establishment is still voluntarily. RMC is measured using dummy variable, if the companies have RMC, it will get 1 point and get 0 for companies that do not.

Results and Discussion

Population of this study is annual report of pharmaceutical corporations listed in the Indonesia Stock Exchange and Bursa Malaysia during the year 2015 – 2019. Purposive method of sampling was used to determine the sample. Number of the samples collected was 110, tested by SPSS24. It used multiple linear regression to test the effect of five independent variables: profitability, leverage, auditor reputation, managerial ownership and risk management committee to the dependent variable corporate risk disclosure; while country used as a control variable. The research model is as follows:

$$\text{CRD} = \alpha + \beta_1\text{PRO} + \beta_2\text{LEV} - \beta_3\text{AR} + \beta_4\text{MO} - \beta_5\text{RMC} + \beta_6\text{CON} + \varepsilon$$

Table 1 presents the result of descriptive statistics test. It reports the results of normalization based on skewness and kurtosis. The values for skewness and kurtosis must fall between -2 and 2. Meanwhile, all the classic tests assumptions Heteroscedasticity and Pearson Correlation are met the criteria. Table 2 describes the Tolerance Coefficients and the VIF for Multiple Regression. Moreover, result of the t-test using Levene Test of five independent variables on dependent variable is reported in Table 3. It tells that only auditor's reputation; risk management committee are having a significant relationship with risk disclosure index.

Lastly, Table 4 shows the result of the hypothesis testing with multiple linear regression. All the tables are presented bellows.

Table 1. Descriptive Statistics

	CDR	PRO	LEV	MO	AR	RMC	2015	2016	2017	2018	2019	Count
Min	0.27	-2.11	.000	.000	0	0	0	0	0	0	0	0
Max					1	1	1	1	1	1	1	1
Mean	.220	1.02	.401	.214	-	-	.20	.20	.20	.20	.20	.45
St. Dev.	.194	7.33	.363	.320	.486	.209	.402	.40	.40	.402	.40	.500
Skewness	.307	-.091	4.66	1.40	-.534	-4.43	1.52	1.5	1.5	1.52	1.5	.185
Kurtosis	-1.40	3.46	3.27	.435	-1.75	1.79	.318	.31	.31	.318	.31	-
		0	4			1		8	8		8	2.002

Note: This table shows the results for correlation analysis for a sample of 110 firm-year observations.

Table 2. The Tolerance Coefficients and the VIF for Multiple Regression

Variables	Tolerance	VIF
Profit Profitability (PRO)	.845	1.183
Leverage (LEV)	.954	1.048
Managerial Ownership (MO)	.780	1.283
Auditor Reputation (AR)	.902	1.109
Risk Mangt Committee (RMC)	.960	1.042

Note: This table shows the results for a sample of 110 firm-year observations

Multiple Linear Regression for T-test

T-tests are used when you have two groups (e.g., males and females) or two sets of data (before and after), and you wish to compare the mean score on some continuous variable. There are two main types of t-tests. Paired sample t-tests (also called repeated measures) are used when you are interested in changes in scores for participants tested at Time 1, and then again at Times 2 (often after some intervention or event). The samples are 'related' because they are the same people tested each time. Independent sample t-tests are used when you have two different (independent) groups of people (males and females), and you are interested in comparing their scores. In this case, we collected information on only one industry (pharmaceutical) but from two different sets of countries (Indonesia and Malaysia)." (Pallant, 2011).

Based on table below, it turned out that only auditor's reputation, managerial ownership and risk management committee are having a significant relationship with risk disclosure index. Meanwhile, the other independent variables (profitability and leverage) are insignificant.

Table 3: T-test using Levene Test

	Levene Test	T-test	Mean Difference
Risk Disclosure	104.155***	-25.327***	-.354717***
Profitability	10.096***	1.213*	1.781633*
Leverage	.982	-.448	-.031267
Auditor Reputation	26.818***	-5.915***	-.490***
Mgrl Ownership	194.716***	4.689***	.280363***
Risk Mgt. Committee	21.600***	2.316**	.083**

Note: This table shows the results for a sample of 110 firm-year observations.

***Correlation is significant at the 0.01 level (1-tailed); **Correlation is significant at the 0.05 level (1-tailed); *Correlation is significant at the 0.10 level (1-tailed);

Table 4. Multiple Regression for Risk Disclosure Index

	Beta	T-test
Constant	.152	(2.051)***
Profitability	-.001	(-.974)
Leverage	.006	(.312)
Auditor Reputation	.067	(3.435)***
Mngr. Ownership	-.020	(-.799)
Risk Mgt. Committee	.110	(3.097)***
Country	-.323	(-16.842)***
Adjusted R Square	.852	
F-stat	63.840***	

Note: ***Correlation is significant at the 0.01 level (1-tailed); **Correlation is significant at the 0.05 level (1-tailed); *Correlation is significant at the 0.10 level (1-tailed).

According to Table 4, the value of adjusted R squared found good at 85.2%. This indicates that the regression model is well explained the relationship between independent variables and dependent variable. Eventually, results of the hypothesis testing showed that the first hypothesis is found that profitability has a negative relationship with risk disclosure index. It could be the lack of information being disclosed by the company as to covered the incompetence of management to stakeholders. This is inconsistent with previous study by (Achmad et al., 2017). Moreover, the result is not significant. Therefore, in this study H1 is not supported.

Meanwhile, leverage is found to be positively related to risk disclosure index. It is consistent with a study conducted by (Utomo & Chariri, 2014). They proved that leverage had positive significant effect in risk disclosure. Thus, the leverage level of corporate is a factor that influence to practice of corporate risk disclosure. Nevertheless, the result is insignificant. Hence, H2 is not supported.

On the other hand, auditor reputation is found in this study to have a significant positive relationship with risk disclosure index. This is consistent with previous studies by Dey et al (2018); Habtoor et al (2017) which proved that auditor reputation has positive relationship with risk disclosure. The agency theory suggests that external auditors have a strong influence in mitigating agency conflicts between managers and investors through enhancing corporate disclosure (Jensen & Meckling, 1976). Thus, H3 is supported in this study.

Managerial ownership, on the other side, is found to be negatively and insignificant related to risk disclosure index. This study is supported by Achmad et al (2017), but inconsistent with Sultisyaningsih and Gunawan (2016), which they found a positive significant relationship. Finally, H4 is not supported.

Finally, the last hypothesis is found to have significant positive relationship between risk management committee and risk disclosure index. The result is consistent with past study done by Al-Hadi et al (2016). They documented that there was positive and significant relationship between the sizes of risk committee on the market risk disclosure. Hence, in this study H5 is supported.

Conclusions, Limitation and Contributions

This research is conducted to fill the gap of those previous studies conclusion for several variables on the influences of financial performance proxy by leverage and profitability and corporate governance proxy by auditor reputation, managerial ownership, and risk committee on risk disclosure by pharmaceutical companies in Indonesia and Malaysia. In addition, this study extends the current literature in the context of pharmaceutical industry in Indonesia and Malaysia that were not explored a lot in the previous studies.

From the analysis, only auditor reputation and risk management committee are having a significant positive relationship with risk disclosure index. It is said that the external auditors have a strong influence in mitigating agency conflicts between managers and investors through enhancing corporate disclosure. When the corporates are audited by the auditor which is a part of Big 4 audit corporates and have good reputation, the corporate could enhance information disclosure specially risk. The auditor which part of the big-4 audit corporates will assist the internal auditor to improve the quality of corporate risk assessment and supervision. Thus, risk disclosure can be disclosing in annual report.

To add on, risk management committee itself is responsible to monitoring the risk strategies, policies and risk tolerance level as well as reviewing the sufficiency of risk management policies. The formation of risk management committee within a corporate governance may enhance the practice of risk disclosure. In addition, it may help corporate to give the signal regarding the risk which might be happen in the future.

This study added on the body of literature of corporate risk disclosure. The findings could help the regulatory bodies to scrutiny the effect of financial performance, leverage and corporate governance on corporate risk disclosure. Furthermore, the findings also added to the body of knowledge of Agency theory. Agency theory explained how the parties involved in the corporate will behave, since essentially between agent and principal have different interests that will lead into agent conflict which could make asymmetry information. Thus, it is necessary to avoid that conflict by avoid any probability that could trigger the existence of asymmetry information.

There are, however, some limitations in this study which provides recommendations for future study. First, this study only focused on the sample from pharmaceutical industry in both countries. The number of samples is only 110 firm-observations in which the results cannot be generalized to other industries. It is suggesting that future research can take more

samples from other industries, so that, the results can be generalized to the whole populations of the public sector companies.

Second, due to the current situation of pandemic Covid-19, most of the companies are having difficulties in running their businesses. Some companies are even having to winding up their business due to disability to rolling the capital. This study is not taken the consideration of such event to determine the risk disclosure index in those pharmaceutical companies. Hence, future research could take a consideration of this pandemic issue whether it could influence the relationship between independent variables and dependent variable in this study.

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