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Book Review

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Mandatory Non-financial Risk-Related Disclosure. Measurement Problems and Usefulness for Investors

Stefania Veltri. Springer, 2020

by Giuseppe Marzo*

The EU Directive 2014/95/EU issued in October 2014 requires large companies within Member States to communicate "quality, relevant, useful, consistent and more comparable non-financial (environmental, social and governance-related) information" (European Commission, 2017). The Directive requires to disclose information on how companies organise and manage social and environmental challenges. Firms have to publish reports on the policies they implement concerning environmental, social, and employee-related matters, respect for human rights, anti-corruption, and bribery. This may help stakeholders evaluate companies' non-financial performance and foster firms to develop a responsible approach to their business (European Union, 2014).

With the issuing of the Directive, the disclosure of Non-Financial (NF) information, previously made voluntarily, has become mandatory. The new situation has attracted the interest of many researchers aiming to investigate the effects of the new mandatory disclosure on the value of firms and their performance.

The book here reviewed is placed in this strand as it focuses "on the mandatory disclosure of non-financial (NF) risks as required by the EU Directive for listed Italian companies, investigating both the state of the art of NF risk-related information disclosure and its usefulness for investors." (p. 3).

The book is composed of 9 chapters grouped in two parts. The first part of the book (Chapters 1-4) is devoted to the analysis of the measurement issues of the Non-Financial disclosure, while the second part (Chapters 5-9) to the empirical analysis.

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Chapter 1 presents the book's structure and aims to give the reader the theoretical background of the research and anticipate the results of the empirical analysis. The chapter is designed as a ready-to-use map for orienting the reader in navigating amongst the chapters. Chapters are clearly linked together. However, each chapter is written to be self-contained, which allows the reader to make flexible use of the book. Using the overview in Chapter 1, the reader can cherry-pick the topics of interest without getting lost.

Chapter 2 deals with risk-related disclosure. Veltri argues that financial and non-financial risks are two very different types of risk, and consequently, the way companies disclose them, and the determinants of their disclosure are different. The literature review presented in the chapter offers the background context for the empirical analysis developed in the book, as it illustrates "the theoretical underpinning of the book, focused on the mandatory disclosure of NF risk-related information."

The chapter also reveals the theoretical lens that the Author employs for the analysis of the mandatory risk disclosure: the material legitimacy theory, i.e., "the form of legitimacy that enables organisations to blend what is important to the organisation (strategic legitimacy) with the primary concerns of its major stakeholders (institutional legitimacy)" (Dumay et al., 2015, p. 20).

Chapter 3 focuses on the path that led to the EU Directive and discusses both the GRI and the Integrated Reporting initiatives and their relationship with the EU Directive. Finally, the chapter highlights how the EU Directive has been translated into the Italian Legislative Decree 254/2016.

The main contents of the EU Directive are here analysed, and the requirements of the Directive are compared to those of GRI and IR along five profiles: the relationship between financial and NF disclosure, the location of NF information, the audience, the rigidity of the content and the materiality principle.

The reason leading the Author to the comparative analysis of the three initiatives resides in the fact that the EU directive requires firms to disclose NF information. However, it leaves them free in choosing the reporting principles and methodologies. GRI and IR are two suitable alternatives to comply with the Directive.

The chapter also deals with the Italian Legislative Decree 254/2016, highlighting the differences from the EU Directive: the scope and the content of NF declaration, how to report NF information, where to position NF information, and, finally, the system of sanctions for missing or inaccurate information.

Unexpectedly, the end of the chapter presents the sample employed by the Author for the empirical analysis (probably, the Author could have better positioned the sample description in the chapters dealing with the empirical analysis). The final sample comprises 51 non-financial listed companies, 45% of which are manufacturing firms and the remaining 55% non-manufacturing firms.

Chapter 4 is one of the most important chapters for the research carried out in the book. In fact, any research aiming at analysing the effect of disclosure or its value relevance needs to measure the disclosure made by companies. The chapter spends many pages discussing how to measure disclosure and provides the reader with an exciting literature review on the most critical issues about the topic. Readers interested in a good analysis of the pros and cons of the various types of methods employed in literature to measure disclosure can refer to this chapter for valuable insights.

The chapter deals with two areas. First, researchers have assigned different categories and labels to the kind of risks investigated. This situation generates confusion as comparing analyses based on different categorisations of risks is challenging. However, the Italian Decree introduces a brand-new categorisation that, being mandatory, should lead towards uniformity in analysis.

The second area of interest is content analysis. The issue at stake is clear: once the problem of risk categorisation has been set or solved by law, a problem remains: how to analyse the non-financial information disclosed by companies.

Veltri discusses the two polar approaches to content analysis: the form-oriented mechanistic approach and the meaning-oriented interpretative approach. The first quantifies disclosure through counting words, sentences, pages items. Therefore, it says nothing about the content of the disclosure. The second one, instead, tries to capture the meaning and nature of themes disclosed. The first is clearly more objective than the second, but objectivity is obtained at the expense of understanding the meaning of disclosed information.

Veltri's content analysis belongs to the meaning-oriented interpretative approach and starts from identifying sentences containing at least one word indicating risk. The analysis has been carried out in a three-stage process. First, a coding scheme based on the Legislative Decree 254/2016 has been prepared. Second, the sentences containing references to risk were assigned to each of the categories of the Decree. Finally, the assessment of the quality of disclosure was performed, basing on the degree of specificity of information, the type of information, and the being the information backwards- or forward-looking.

After completing the process, the Author calculated a disclosure quality index employed in empirical analyses run in the second part of the book.

Chapter 5 tests the relationship between financial and non-financial risk disclosure. The topic, already introduced in Chapter 2, is now investigated empirically. After a literature review that introduces the reader to the puzzling situation existing around the relationship between the disclosure of the two types of risk, the Author presents her first research hypothesis: Financial risk disclosure affects the quality of NF risk disclosure.

The Author measures the financial risk disclosure as the natural logarithm of provision for risks and uncertainties (following IAS 37) and employs the disclosure quality index calculated in Chapter 4. The analysis shows a negative and statistically significant association between the disclosure of the two kinds of risks. In other words, a substituting effect exists between them.

Chapters 6, 7 and 8 should be taken together. Chapter 6 presents the theoretical model for the value relevance analysis, and Chapters 7 and 8 apply the model to the financial risk and the NF risk disclosure.

The Author clarifies that the value relevance analysis is based on a semi-strong market efficiency theory, positing that market values incorporate all publicly available information. Without this assumption, indeed, the contribution that any disclosure can give to the market value of a company cannot be tested.

Second, the Author presents and discusses the value relevance model adopted in her research: the Ohlson Model. There is a significant acceptance of the model in the value relevance literature, and these vast amount of studies offers valuable insights into the use of the model even for the analysis carried out in the book.

Chapters 7 and 8 apply the Ohlson model to investigate the value relevance of financial and non-financial risk disclosure.

The two chapters have a symmetrical outline, as they start with the review of the most relevant literature streams and then proceed with the empirical analysis.

Studies testing the value relevance of financial risk disclosure have returned puzzling results. In general, they found that disclosure is useful for investors. However, the sign of the effect is questionable, as information given to investors can either increase or decrease their risk perception, with opposite effects on the firm's value. The analysis carried out in Chapter 7 supports a positive and statistically significant association between financial risk information and the firm's value.

Chapter 8 replicates the analysis of the previous chapter but for the NF risk disclosure. Even in this case, the literature analysis shows two different results, as some studies found a positive association between NF risk disclosure and the firm's value, and others a negative association instead. The empirical analysis run on the NF risk disclosure of Italian listed companies displays a positive and statistically significant association.

Chapter 9 closes the book by offering the reader what could be considered the main novelty of the research: the mediating role of NF risk disclosure. In general, literature on risk disclosure has been concerned with investigating the direct effect of the disclosure on the firm's value. The book offers an original view based on the hypothesis that the NF risk disclosure acts as a mediator between the financial risk disclosure and the firm's value. The results of the analysis support the hypothesis.

The book offers several benefits to the reader.

First, the book supports the empirical analysis with a well-focused literature review. Veltri has collected and analysed the most influential papers for each of the topics explored and summarised their findings. This way, readers interested in discovering the evolution of the research on risk disclosure can find in this book what they need.

Second, the book explores the effect of mandatory disclosure under the new EU Directive as translated in Italy. As the Directive and the Italian Decree are very recent, the need to investigate the new reality is paramount to derive functional implications for practitioners, companies, standard setters and regulators.

Finally, the book offers valuable and non-obvious insights into the mediating role of the NF risk disclosure, which is not common in literature.

In the reviewer's opinion, two additional insights could magnify the analyses carried out in this book.

First, the move from voluntary to mandatory disclosure is usually complex, as self-regulation and government regulation often interact (Jackson et al., 2020). Government can intervene either by defining new standards and incentives to disclosure (Fox, Ward, and Howard, 2002; Steurer, 2013) or by hardening existing forms of voluntary disclosure, reframing them in some specific legal frameworks (Gond & Nyberg, 2016; Moon, Kang, & Gond, 2010). Different forms of mandatory disclosure are expected to have different effects on both the level and the quality of disclosure and its association with the firm's value.

Second, the analysis of the effect of mandatory disclosure could be better understood if compared to the role that voluntary disclosure played before the regulation. A recent analysis (Cordazzo and Marzo, 2020) unveils that most of the listed Italian companies replicated the standards and practices adopted for their voluntary disclosure to comply with the new regulation. Such a situation could be responsible for a moderate increase of non-financial information after the Legislative Decree application (Cordazzo et al., 2020). Given this, it is not easy to distinguish the role of mandatory from voluntary disclosure.

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