

# Text Mining of Risk Factor Disclosures in Annual Reports

Presented by: Yue Liu

# Item 1A - Risk Factors

- Firms report “Risk Factors” in their 10-K item 1A (beginning in 2005)
  - Discuss factors that make an investment in the registrant’s securities speculative or risky and should be concise and organized logically.
  - Some risks may be true for the entire economy, some may apply only to the industry, and some may be unique to the company. (SEC)
  - Companies generally list the risk factors in order of their importance (SEC 2011). However, not a requirement yet. SEC is asking for comments on whether risk ranking should be mandated.

# Research on Informativeness of Item 1A

- Risk factor disclosures are associated with firm-level risk measures, such as beta or stock volatility – focus on a broad range of risk types (e.g., Bao and Datta 2014; Campbell et al. 2014)
- More specific risk factor disclosures benefit financial statement users by enhancing their risk understanding. (Hope, Hu, and Lu 2016)
- Disclosures of specific types of risks are informative of certain outcomes. (e.g., Beatty et al. 2015, Campbell et al. 2017, Gaulin 2017, Hail et al. 2017)

# Objectives of our project

- Study the informativeness of some specific types of risk factor disclosures and how it can be useful for the stakeholders
  - Credit risk and credit rating (done)
  - Internal control risk and internal control weaknesses and audit efforts (to be done)

# Examples of credit risks (summaries)

- **Example 1:** Our access to liquidity may be negatively impacted if disruptions in credit markets occur, if **credit rating** downgrades occur or if we fail to meet certain covenants. Funding costs may increase, leading to reduced earnings.
- **Example 2:** Our substantial indebtedness could adversely affect our operations, including our ability to perform our **obligations** under the notes and our other **debt obligations**.

# Credit risk factors and credit ratings

- Findings:
  - Managers provide information through ordering of risk factor disclosures.
  - Credit risk rank is associated with credit rating levels.
  - Managers move up credit risk disclosures in response to rating downgrades.
  - Credit risk move up predicts future ratings.
  - Firms at the bottom the investment rating (BBB+,BBB,BBB-) are less likely to move up credit risk disclosures

# Future research

- Look at internal control risk factors: are they providing incremental information to stakeholders?
- Specifically, firms are not required to disclose significant deficiencies that do not achieve the materiality level in ICFR reports, but managers could use the risk factor section to signal the internal control risks
- How will it affect audit decisions?

Thank you!