

# The role of disclosure quality in financial reporting

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## Abstract

Great emphasis has been put on the quality and importance of financial information disclosure in the theoretical foundations of accounting. This research focuses on the role of disclosure quality in financial reporting. The main reason behind choosing this subject was the criticality of financial information disclosure in the current world of trading. The current research is descriptive-scientific in nature and uses library research methods. In this research, we reviewed the quality and definitions of disclosure, discussed mandatory and voluntary disclosure, disclosure levels, and disclosure audience, and at the end, reviewed and determined the relationship between the quality of disclosure and characteristics such as information asymmetry, profit management, capital expenditure, and corporate size.

**Keywords:** Voluntary disclosure, Information asymmetry, Disclosure quality, Profit management, Capital expenditure

## Introduction

During the past years, many researches have been carried out on the quality of financial information disclosure and its relation to corporate characteristics. The main goal of accounting systems and financial reporting is to provide the users of financial information with the information that proves useful to them in their economic decisions. In the new directive of Iran's bond market, considerable attention has been paid to transparency and information giving in the same market. According to the fact that the users of financial information consider financial reports as one of the major sources of financial information, these reports must be created in a way that they prove useful to the financial information users while making economic decisions.

## Review of related literature

### *Disclosure audience*

Those who make use of financial reports are from all walks of life, with different aims and knowledge level, having so many interests and various information requirements (Malekian, Adili, Emrahimian, & Amirpour Mola, 2011). Before defining the disclosure, we have to explain one of the main questions as to whom financial information should be disclosed. Thus, the question deals with the importance of disclosure audience and the answer, is that those who make use of accounting information include two primary and secondary groups. The primary users are divided to investors and credit providers; while secondary users include various groups such as government, banks, people, employers, etc. One of the reasons that the second group's requirements is not emphasized upon is that there is no enough information as to the nature of their decisions. However, investors and credit providers' pattern of decision making is rather clear and well defined (Shabahang, 2011).

Investors and credit providers are considered the two fundamental user groups, as far as financial information is concerned, and to provide them with this information is one of the accounting missions (Arab & Arzitoon, 2007). Since there is no exact data of nature of decisions made by the other users, they are entirely supposed to take advantage also of the same information beneficial for investors and credit providers (Shabahang, 2011). As the main role of financial reporting is reliable transfer of information to the outsiders in time, and effectively, managers could apply their own business knowledge to improve the effectiveness of financial statements as a mean of information transfer to potential investors and credit providers (Noroush, Hosseini, 2009). The extent of disclosure is influenced

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by the amount of information provided, as well as users' expertise (Setayesh, & Kazemnezhad, 2010). Sometimes different countries put beneficiary groups e.g. employers and governmental institutions in the same group with investors, and this way informational needs of this group are equally paying attention to by these countries (Shabahang, 2011).

### *Disclosure definition*

Disclosure term, in the widest sense, is meant to provide information. In accounting, the term is used in a more limited way and is meant just presentation of financial information of the company in financial or annual reports. In some cases, the disclosure will be even more limited, and it means the presentation of financial information which is not provided in the financial statements. So, disclosure in the most limited definition includes management analysis and discussion, descriptive notes coupled with financial statements, and complementary financial statements (3) (4) (7) (10). Information disclosure is the center resource efficiency in capital market, and any information would affect investors' decisions should be revealed by companies (2).

There are many definitions about disclosure some of them are as follows:

A. Adequate and timely financial information about a Company's activity (6)

B. Economic information transfer and presentation whether financial or non-financial, quantitative or other related forms of financial performance of a company (5)

C. A variety of mandatory and voluntary information includes financial statements and accompanying notes, report of the board of directors, management analysis, management prospects and ... (Hasas Yeganeh, 2006).

D. Information preparing process for a Company's financial reporting

One definition of disclosure which is mentioned in operating instructions of companies recorded with the Stock Exchange of Tehran is transmission of information timely to the public release in accordance to the instruction.

Disclosure meaning is that published financial statements and related notes should contain any economic information which is related to accounting personalities that are sufficiently important to affect aware and careful user decisions.

### *Quality of Disclosure*

Empirical studies do not give precise and specific differentiation between the quantity and quality of disclosure. It is generally assumed that the quan-

tity of disclosing information is an indicator of its quality. However, some believe that the quality and quantity of disclosure are separated from each other and that quality refers to the precision or accuracy of the disclosure. The term quality of accounting information disclosure and transparency of a disclosure system are used (Setayesh, & Kazemnezhad, 2010).

One factor to determine the quality of disclosure in Iran is the corporate disclosure rating of the Tehran Stock Exchange. This rating reflects the evaluation of the said organization about the information content of companies' disclosure. The scores are calculated based on the weighted average of the timeliness and reliability of disclosing information criteria (Yaqub Nejad, & Zabihi, 2011).

In this regard, appropriateness, comprehensiveness, being informative and timeliness are other criteria for the quality of disclosure.

Sinqvavi and Desai argue that quality refers to the completeness, accuracy or precision, and reliability features. In general, quality is the limits financial reports reveal the main economic activities of a business unit so that it is easily conceivable for the users of those reports Setayesh, & Kazemnezhad, 2010).

### *Disclosure Levels*

The level of information that must be disclosed partly depends on the skills (or needs) of users. On FASB, for example, it is ordained that the information disclosed in reports must be understandable for the people with relative understanding about the economic and commercial activities. The level of disclosure also depends on the standards in this context (Karbasi, 2007).

There are three concepts of the disclosure including adequate disclosure, fair disclosure, and full disclosure. Definitions of these concepts are as follows:

*Adequate Disclosure:* The most common used term is adequate disclosure. This means that the disclosure must be low and non-misleading (Karbasi, 2007). The adequate disclosure is providing the minimum required information so that users may not be misled (Setayesh, & Kazemnezhad, 2010). Adequate disclosure indicates the minimum disclosure requirements. In other words, it indicates that the financial statements should not be misleading (Arab & Arzitoon, 2007). As we can see, all above definitions emphasize on not misleading of users.

*Fair Disclosure:* This indicates that the disclosure must be identical for all potential users of financial statements, and this is an ethical goal (Karbasi, 2007). Fair disclosure considers all types of users equally (Setayesh, & Kazemnezhad, 2010).

This type of disclosure emphasizes on identical deal with all potential users of financial statements (Arab & Arzitoon, 2007).

*Full Disclosure:* Full disclosure indicates providing all relevant information. For some users, the full disclosure means providing all information, and this is an inappropriate concept. These users believe that the excessive disclosure of the information is harmful because providing unimportant details conceals the main information and makes the interpretation of financial statements difficult (Karbasi, 2007). Full disclosure means providing all relevant information (Shabahang, 2011). Another definition of full disclosure indicates providing all information so that a full image of the entity's financial events and activities can be reflected (Noroush, Hosseini, 2009).

But if the three above definitions are considered appropriate, there will be no real difference between them (Shabahang, 2011).

### *Voluntary Disclosure versus Mandatory Disclosure of Financial Information*

Many accounting experts believe that companies voluntarily disclose all the information required for the optimal functioning of capital markets. On the contrary, other accounting researchers claim that the evidence shows that companies are reluctant to disclose additional information if not required by the accounting profession, and public and legal authorities (Shabahang, 2011).

Before judging the desirability of mandatory disclosure and voluntary disclosure, their definitions must be provided:

#### *Voluntary Disclosure*

If the disclosure is not affected by certain laws, it is considered voluntary (Sajadi, Zaranezhad, & Jafari, 2009). Voluntary disclosure is beyond the disclosure where there is no provision for enforcing the rules for disclosure. On this basis, voluntary discloses the process of preparing information for corporate reporting in financial markets, even though there is no legal requirement (Pankaj, 2007).

#### *Mandatory disclosure*

If a financial information disclosure becomes necessary due to an authority enacting rule, it is considered mandatory (Sajadi, Zaranezhad, & Jafari, 2009).

Recently, emphasis has been put on the voluntary disclosure and raising the transparency of the disclosed information. The main reason for this emphasis is that it is the basis for shareholder support.

Full disclosure along with transparency in financial reporting can increase trust and confidence of stakeholders (Pankaj, 2007). The two factors among the factors considering voluntary disclosure more desirable than mandatory disclosure is as follows:

A very simple view that can be offered is that the manager will disclose all information, whether good or bad. If investors know that the manager has information but they don't know what this information is about, they will assume that the manager will announce it if it is desirable. Therefore, if investors see that the manager does not disclose the information, they will assume the worst possible situation and offer the prices in a way that the company's stock market value decreases whereas the companies currently aim to maximize their value. Accordingly, the manager's motivation to prevent the company's stock market prices from falling will lead to increased voluntary disclosure by the manager William (2012).

The other factor involved is that if a company does not disclose the information, investors' information decreases due to information asymmetry. Consequently, the company's share turnover will decrease and the company's stock market value decreases too. The evidence suggests that there is a direct relationship between increased information asymmetry among managers and shareholders, decreased number of shareholders, and the company's share turnover that leads to decreased stock liquidity. Therefore, the company and managers will voluntarily disclose the information in order to prevent the company's decreased stock market value (Setayesh, Kazemnezhad, & Zolfaghari, 2011).

About the company's life, it is believed that more experienced and better organized companies are more likely to voluntarily provide more information in their annual report than the younger companies (Sajadi, Zaranezhad, & Jafari, 2009).

### *Relationship between disclosure quality and information asymmetry, earnings management, capital expenditure, firm size*

#### *Relationship between disclosure quality and information asymmetry*

According to agency theory, managers as representatives of shareholders may take such action-which are not necessarily in order to maximize shareholder wealth. According to this theory, control mechanisms should be performed to protect shareholder against profit conflict (3). So, information asymmetry is because of the profit conflict between managers and shareholders.

Capital market participants are always looking for reliable and good financial data because these data reduce information asymmetry between company management and outside investors. Based on numerous studies about accounting literature, information asymmetry is reduced by achieving higher quality of disclosure (14). So, disclosure quality is one of the concepts can help to reduce information asymmetry and profit conflict effectively, and finally causes firm value increasing (9). It means there is the negative correlation between disclosure quality and information asymmetry.

#### **Relationship between disclosure quality and earnings management**

Earnings and its associated components are such information that users interest in and since in accordance to accepted standards; accounting earnings is measured based on the commitment, managers have greater opportunities to engage in earnings management (9). Earnings management is defined as: managers to create ambiguity in the inherent value of the company or influence resource use judgment in financial reporting deliberately. Evidence shows that earnings management among firms has become a common procedure (14). It should be noted that the level of earnings management proportional to the level of information asymmetry increases, it means information asymmetry between management and investors are necessary for earnings management.

Since the improvement of company disclosure quality causes reduction of information asymmetry, and reduction of information asymmetry of management is associated with lower earnings so, there is the negative correlation between company disclosure quality and earnings management (14). In the long term, those companies with high earnings management and less disclosure quality obtain a stock price below the value which means there is a direct correlation between the quality of disclosure and firm value (9).

#### **The Relationship between Disclosure Quality and Capital Expenditure**

As it has been mentioned before, there is information asymmetry between managers and shareholders. The same asymmetry could also be seen between different investor groups. Informed investors have access to confidential information, while non-informed investors have only access to general information. Disclosure quality could affect such information asymmetry through the trading behavior of non-informed investors (Malekian, Adili, Emrahimian, & AmirpourMola, 2011).

Bootasan (1997) reported that the result of his tests showed that the quality of disclosed information was directly related to the decrease of capital expenditure William (2012). With the spread of information in the market, bond trading will increase so the investors could achieve the portfolio of optimal investment. The increase in bond trading will lead to an increase in the bond's liquidity and a decrease in the bond trading expenditure. This is actually the way capital expenditure decreases.

When the quality of disclosure increases, not only more investors will take part in corporate bond trading but also their efforts to access confidential data will decrease. As the information asymmetry decreases, the cost of trading will decrease too, while the demand for corporate bonds will increase. This leads to a decrease in capital expenditure Setayesh, Kazemnezhad, & Zolfaghari, 2011).

#### **The Relationship between Disclosure Quality and Corporate Size**

According to some researches, there is a relationship between disclosure quality and the size of a for-profit firm (Shabahang, 2011). Considering the factors affecting corporate characteristics, the size of the company is one of the most important factors in rating the companies based on their financial data disclosure. In most of the researches on disclosure, the firm size is considered as an important characteristic concerning the level of disclosure.

## **Conclusions**

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It is suggested to the future researchers that they study the social disclosure of companies, disclosure for secondary groups including government, banks, society, etc. and whether such disclosures are possible concerning the subject of cost-benefit.

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