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The Impact of the quality of Business Risk Disclosure and Financial Performance on Investor's Judgment

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ABSTRACT

This study investigates the investor's subjective judgment based on the disclosed business information. Disclosure of useful and quality information can improve Investor's decision making in the capital market. One of the information disclosure channels is the management commentary. Present research examines the impact of the quality of business risk disclosure of management commentary and financial performance on investor's investment decision making in a sample of 85 professional traders in the special economic zone Amirabad Port (Mazandaran, Iran) in 2022-2023, using a scenario-based questionnaire. For the testing of the research hypotheses, univariate analysis of variance (in PLS) was used. The results indicated that the disclosure quality of financial performance and business nature positively influenced the investor's willingness to invest in Amirabad Port. The results further indicated that when there is a quality risk disclosure and financial performance, investors tend to consider the company's profit higher.

KEYWORDS: Quality of Business, Risk Disclosure , Financial Performance , Investor's Judgment

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1. Introduction

Information disclosure provides insights to standard setters, legislators, consultants, and auditors who seek to develop guidelines for disclosure of non-financial information (Bini et al, 2018). By providing useful information, management can influence judgment of professional investors. In this regard, the standard setting committees have furnished the guide to the application of the standards with descriptive and interpretive examples regarding the company's current performance. Based on this, managers are required to give the reason for the change in sales and cost price of the sold products in management commentary. The management commentary standards are aimed to improve the usefulness of the information supplied in the management commentary of a business unit. The supply of this commentary on and together with the financial statements prepared according to the accounting standards is instrumental to the users (Li, 2017). Integrated reporting of business dimensions and integration of sustainable financial and non-financial performance provide better information for decision making and since gaining investors' trust for investment in the capital market requires increased transparency in supply of financial and non-financial information, companies may decide to expand their disclosure policies and as a consequence, voluntarily disclose the business model as an important economic instrument (Maniora, 2017).

The disclosure of the business model and its components can increase the value of accounting information and thereby, increase the value of company's shares. The disclosure of business models reduces information asymmetry and increases information transparency, thereby reducing uncertainty and ambiguity. As a result, investment is made with lower risk (i.e. lower cost of capital) that corresponds to a lower rate of return. The reduced uncertainty and risk (cost of capital) is likely to result in an eventual rise in the firm's value (Mechelli et al, 2017).

The majority of companies report sparingly or make no disclosure on R&D. Meanwhile, companies with higher liquidity and market-to-book ratio show more willingness to make R&D disclosures (Dyczkowska, 2016).

As financial statements mainly reflect the financial effects of past events, and do not inform on non-financial performance measures or the business outlook and future plans, they do not provide all the needed information of users for economic decision making. These limitations have led companies to supplement financial statements with a management commentary (Bao & Datta (2014). In a management commentary, the quality of the disclosed information regarding the business nature matters for elucidating the company's financial performance. Policymakers have made it mandatory that management commentaries should include aspects that help understanding of the business performance and inform on the contributing factors hereto. These factors include introduction of a new product, changes in exchange rate, changes in holding's policies, changes in costs, and halted operations. Therefore, the quality of the information provided on business nature is enhanced when it is furnished with a commentary (Miihkinen, 2012).

Management commentary is a descriptive report that, irrespective of the supplied numbers and digits, creates a context for interpretation of financial situation, financial performance, and cash flows of the business unit and gives the company's management the opportunity to explain its goals and strategies to attain these goals. Management commentary is a narrative description from the perspective of company managers. The purpose of the management commentary rules or standards is to improve the usefulness of the information presented in this report. Its presentation in relation to and together with the financial statements prepared according to accounting standards benefits users and improves their decision making on providing resources for the business unit (Davies et al, 2010).

Management commentary is an information source for disclosure of non-financial information. Disclosure of non-financial information can be addressed from the two perspectives of stakeholders theory and legitimacy theory. According to stakeholder’s theory, information disclosure is influenced by internal and external stakeholders. Different stakeholders exercise influence over goals setting and operation of the company and the company discloses information in different aspects for different uses in accordance with information needs of stakeholders. Based on stakeholder’s theory, disclosure of non-financial information in the form of management commentary is indicative of stakeholders' influence and purposes. The made disclosures in management commentary are meant to meet different needs of the company's stakeholders.

From the perspective of legitimacy theory, companies constantly try to ensure that their activities are within certain norms and information disclosure reflects the correspondence of the supplied company information with community expectations. According to this theory, voluntary disclosure of non-financial information in the form of management commentary indicates the degree of corporate adjustment (conformity) to social norms and its responsiveness to community expectations (Solomon et al, 2000). Based on this background, the present study investigates the likely impact of the quality of business risk disclosure and financial performance on investor's judgment.

2. Theoretical framework and research background

Since late 20th century, the interest in intangible asets and their impact on firm's market value has encouraged companies to increase investment in human resources, R&D, and new technologies. To maintain competitive advantages and increase share value on the market, presentation of real value of intangible assets in balance sheet has become important. This is while the current accounting system does not meet the information needs of the age of knowledge and is not able to adequately measure and disclose intangible assets. According to current accounting standards, most of the intangible investments of the business unit are either recorded in cost account or arbitrarily amortized (Buzinskiene, 2017).

In the transportation market, the high level of the provided services creates competition between seaports, and providing higher provided services earns the company more customers

(Yang Yanbing, 2005). Seaports as the chief link in product supply chain are also considered one of the attractive settings for logistical applications. In the supply chain, the port acts as a mediator between land and sea and communication integration along this chain is imperative. This is while the industrialization and development in the emerging markets as well as the change of trend anf logistical conditions, and varying customer needs have made fundamental transformation in ports inevitable. Today, customers and product owners look for a wide range of diverse services. Satisfaction of good senders is very important as they consider those carriers desirable that best meet their needs (Premeaux et al, 1995). Thus, a port's competitiveness depends to a great extent on the port's ability to integrate the supply chain.

Rezaei et al (2021), in a research titled Investigating the Quality of Risk Disclosure of Management Commentary and Financial Performance of the Company on the Investors' Judgments, found that under conditions of increasing (decreasing) financial performance, high (low) quality of risk disclosure increases (decreases) professional investors' willingness to invest in the firm. Rabiee et al (2020) investigated the factors associated with voluntary disclosure. They, using a mixed method, identified factors such as voluntary access to information, form of voluntary disclosure, attention to type of industry and users, information qualitative features, analytical disclosure, and future disclosure to have a positive and significant effect on voluntary disclosure. Hosseini and Malekian (2020) investigated the relationship between voluntary disclosure and financial performance and earnings management and found a significant relationship between financial performance indicators, earnings management, and voluntary disclosure, implying that a higher level of voluntary disclosure is associated with an increase in financial performance.

Lee and Park (2019), in a research titled The Impact of Audit Committee Financial Expertise on Management Discussion and Analysis (MD&A) Tone, noted that the effect of financial expertise is most evident when the audit committee is more powerful or members of the audit committee are faced with higher litigation risks. Bochkay and Levine (2019) investigated the use of MD&A for improvement of earnings forecasts on a sample from the US in the period 1994 through to 2012 and showed that information disclosure in management commentary had an effect on future earnings forecasts. They also found that management commentary generally improved the firm's informational environment. Li (2017), in a study titled Level of Business Insights in the MD&A and Nonprofessional Investors' Judgments, examined the effect of the level of insight into management commentary and financial performance on investor's judgment. He found that with a management commentary on unexpected increasing (decreasing) performance, investor's judgment about earnings permanence takes an upward (downward) course. Lindrianasari et al (2017) investigated investors' reaction to management discussion and analysis in the listed companies on the Indonesian stock exchange and showed that the Indonesian capital market positively reacted to management commentary disclosure.

Drawing on the theoretical framework, in this research, quality of business risk disclosure and quality of financial performance are the independent variables and investor's judgment is the dependent variable.

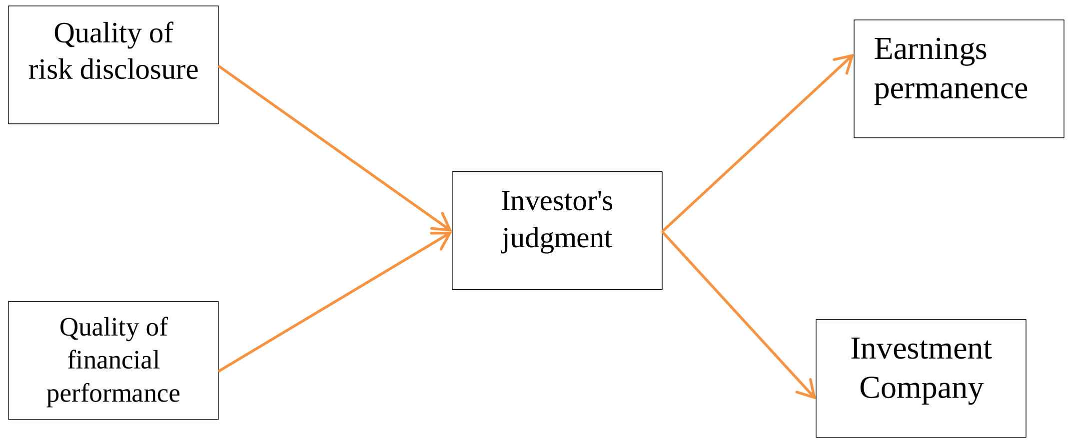

Figure 1. Research conceptual model

Based on the conceptual model, the following hypotheses are made.

H1. Quality of risk disclosure has a significant relationship with investor's investment judgment in Amirabad Port.

H2. Quality of financial performance has a significant relationship with investor's investment judgment in Amirabad Port.

H3. Quality of risk disclosure has a significant relationship with investor's judgment in having earnings permanence.

H4. Quality of financial performance has a significant relationship with investor's judgment in having earnings permanence.

3. Methodology

This is an applied research with a quantitative (comparative) approach conducted through a descriptive survey using a scenario-based questionnaire.

The statistical population and sample included CEOs and CFOs of all 43 investment companies based in the special economic zone Amirabad Port. Eventually, 85 of the executives with master's, bachelor's, and associate degrees who had been selected by simple random sampling answered the questionnaires. This rate of response, given the sample size (70) obtained from Krejcie-Morgan table, was highly representative.

The questionnaire was adapted and validated consulting the supervisor and other professors with expertise and knowledge of the field.

A preliminary test of reliability was performed by distributing the questionnaire among 30 respondents, according to which the obtained Cronbach's alpha for all variables of information sharing level and the whole questionnaire was more than 0.7. Next, the obtained data from the whole sample was analyzed in SPSS and the SmartPLS4 software, using structural equation modeling (SEM) technique for PLS.

4. Findings

In this section, the results of confirmatory factor analysis of each research variable by SmartPLS 4 are presented. The strength of the relationship between the latent and observable variable is given by the factor loading. Factor loading is a value between zero and one. If the factor loading is less than 0.4, the relationship is considered weak and is ignored. A factor loading between 0.4 and 0.6 is acceptable, and if it is greater than 0.6, it is very desirable (Klein, 2010). The factor loadings of the research variables were calculated separately as shown in figure 2.

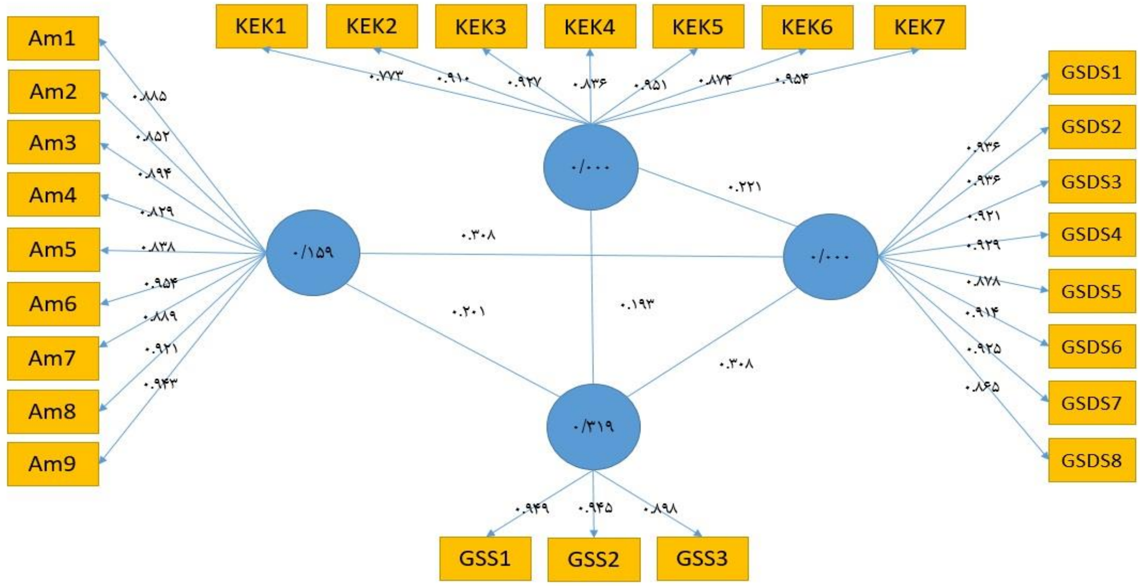

Figure 2. Factor loadings of model components in standard state

As can be seen in the figure above and table 1, in all the model's constructs, factor loadings have values greater than 0.4. Hence, the reliability of measurement models is acceptable. Having measured the factor loadings of the questions, Cronbach's alphas and composite reliability (Dillon–Goldstein's ρ) were computed, the results of which are reported in the table below.

Table 1. The results of Cronbach's alpha, composite reliability (CR), and convergent validity

Dimension	CR	Cronbach's alpha	Convergent validity (AVE)

KEK	0.936	0.929	0.78
AM	0.872	0.846	0.874
GSDS	0.855	0.844	0.779
GSS	0.951	0.923	0.866

As is seen in the above table the obtained Cronbach's alpha for all dimensions is greater than the threshold of 0.7, hence the research reliability is confirmed.

To test the composite reliability (CR) of each construct, the Dillon-Goldstein coefficient (ρ) is used. The composite reliability reported in table 1 for each construct is greater than the threshold 0.7, hence composite reliability of the constructs are confirmed.

Another criterion in examining the measurement model fit in terms of internal consistency of the constructs is convergent validity which is measured by average variance extracted (AVE). In the table above, the obtained AVE for all constructs is greater than the minimum acceptable value 0.5, whereby the convergent validity of the model is confirmed.

We also use the measure heterotrait-monotrait ratio (HTMT) to assess discriminant validity. If the HTMT value is less than 0.90, there is discriminant validity among the constructs (Henseler et al, 2015).

Table 2. Discriminant validity by HTMT

HTMT	KEK	AM	GSDS	GSS
KEK				
AM	**0.760**			
GSDS	**0.680**	**0.708**		
GSS	**0.477**	**0.979**	**0.724**	

Overall model fit

Chen (1998) proposed three values of 0.19, 0.33 and 0.67 as criterion values for weak, moderate and strong R^2 values, respectively, as the indicators of the structural model overall fit.

Table 3. R^2 values

Variable	**R^2 value**	**Q^2**
KEK	0.159	0.178
AM	0.319	0.180

The second structural model fit index is the Q^2 index. This measure indicates the predictive power of the model regarding an endogenous construct. As a rule, Q^2 values of 0.02, 0.15 and 0.35 indicate weak, moderate and strong predictive power corresponding to an exogenous construct, respectively. Given the R^2 and Q^2 values, as reported in table 4, the structural model overall fit and predicting power is confirmed.

According to Henseler et al (2014), a standardized root mean squared residual (SRMR) value of below 0.1, and in a conservative case, of 0.08, indicates the model adequate overall fit.

Table4. The results on the overall model fit using standardized root mean squared residual (SRMR) and NFI index

Latent variables	Saturated model	Estimated model
SRMR	0.088	0.088
NFI	0.552	0.552
d_ULS	3.324	3.324
d_G	1.621	1.621

The NFI index, which is called the Bentler-Bonnet index, is a comparative fit index. This index assesses the model by comparing the chi-square values of the independent model and the chi-square of the saturated model. An NFI value above 0.9 is acceptable, indicating the model suitability. Bootstrap provides confidence intervals for the two values discrepancy. Values greater than 0.05 for d_ULS measure (i.e. the Euclidean least square discrepancy) and d_G (i.e. the geodesic discrepancy) indicate good model fit. The obtained d_ULS and d_G values in the above table which are more than 0.05 indicate the model good fit.

By default, PLS4 software tests relationships at the 95% confidence level, and since the t-value at this interval is equal to 1.96, any relationship with a t-value outside the range of -1.96 to +1.96 is considered statistically significant at the 95% confidence interval.

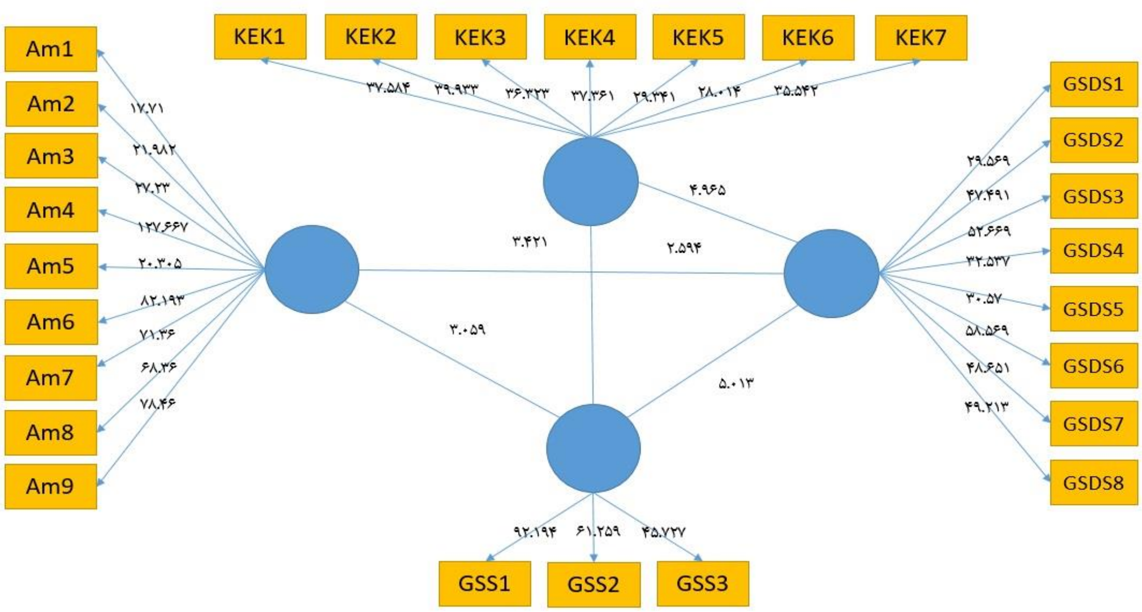

Figure3. Significance coefficients of the conceptual model

The t-statistic shows the significance of the relationship between the variables. A t-value greater than 1.96 indicates a positive and significant effect; a t-value between -1.96 and +1.96 indicates the lack a significant effect; and a t-value smaller than -1.96 indicates a negative and significant effect. Also, if the path coefficients are above 0.6, it means that there is a strong relationship between the two variables; If it is between 0.3 and 0.6, there is a moderate relationship, and if it is below 0.4, there is a weak relationship. As shown in the model, all the hypotheses of the model are confirmed as their t-value falls outside the specified range, indicating the significance of all hypotheses and relationships between variables at the 95% confidence interval. The results on the test of the research hypotheses are presented in the table below.

Table 5. Results on the test of the hypotheses

Hypothesis	Path	Path coefficient	t-value	Test result
1	KEK-> GSS	0.193	3.421	Accepted
2	AM-> GSS	0.201	3.059	Accepted
3	KEK->GSDS	0.221	4.965	Accepted
4	AM->GSDS	0.308	2.594	Accepted

Given the results in the above table, all the research hypotheses are confirmed.

5. Discussion and conclusion

The test of the first hypothesis indicates that with an increase in quality of risk disclosure, investor's willingness to invest in Amirabad Port increases. This result is consistent with the finding of Li (2017). It follows that in a condition where there is a high quality of risk disclosure which provides useful information on the reasons for the change in the course of the company's financial performance, people are more willing to invest in the port.

The test of the second hypothesis indicates that financial performance has an effect on the investor's willingness to invest in the port. This implies that the interaction of the quality of risk disclosure and quality of financial performance is highly relevant to willingness to invest in this port and investment in companies with a higher quality of risk disclosure and better financial performance is more likely to increase. Similar results are reported earlier by Rezaei et al (2021). The test of the third hypothesis indicates that there is a relationship between quality of risk disclosure and investor's judgment in earnings permanence, which is consistent with the findings of Hosseini and Malekian (2020). It follows that with an increase in the quality of risk disclosure and useful information supply, investors can better study and analyze the causes of the change in financial performance in terms of earnings permanence.

The test of the fourth hypothesis indicates that quality financial performance has an effect on the investor's willingness to invest in Amirabad Port with an eye on earnings permanence. However, in this type, high quality of business risk disclosure has no effect on investor's judgment regarding earnings permanence. This implies that the interaction of quality of risk disclosure and financial performance does not affect decision making regarding earnings permanence.

Based on the above findings, it seems that the investors in prediction of earnings permanence have more emphasis on quality of risk disclosure and do not consider financial performance (i.e. the investors are not negatively biased).

Overall, the results of this research are most consistent with the findings of Rezaei et al (2021).

Considering the importance of the quality of business risk disclosure for investor's decision making regarding earnings permanence, the standards authorities and regulatory bodies can address this concern among the investors by introducing disclosure standards that give better insight into the business operations and financial prospects.

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ETHICAL CONSIDERATION

Authenticity of the texts, honesty and fidelity has been observed.

CONFLICT OF INTEREST

Author/s confirmed no conflict of interest.