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Research Paper

The Impact of Different Information Environments on the Relationship between Disclosure Quality and Idiosyncratic Stock Risk: A Principal Component Analysis Approach[1]

Shokrollah Khajavi[2], Mehran Jahandoust Marghoub[3], Soraya Weysihesar[4]

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INTRODUCTION

Investors are always looking for ways to generate suitable income from their investments. As most investors are risk-averse, they are constantly seeking to maximize their expected returns at an acceptable level of risk or minimize their risk at an acceptable level of expected return (Healy & Palepu, 2001). Management forecasts are one of the optional disclosures available to managers to provide investors with additional information about the company's expected future performance (Anilowski et al., 2007). When managers, as informed individuals, provide forecasts of the company's future to shareholders, the company's valuation improves (Durnev & Kim, 2005), the cost of capital is reduced (Francis et al., 2008), information risk is reduced (Ferreira & Laux, 2007), and investors are more confident in evaluating future cash flows (Rogers et al., 2009). Since managers have more accurate information than individuals outside the company who do not have access to it (Jensen & Meckling, 1976), they can reduce the company's risk with accurate and reliable forecasts (Zalaghi et al., 2014).

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1. DOI: 10.22051/JFM.2020.28406.2219
2. Professor, Department of Accounting, Shiraz University, Shiraz, Iran. Corresponding Author. Email: shkhajavi@rose.shirazu.ac.ir.
3. Ph.D. Student, Department of Accounting, Mazandaran University, Babolsar, Iran. Email: mjahandostm@yahoo.com.
4. M.Sc. Department of Accounting, KAR Higher Education Institute, Qazvin, Iran. Email: soraiaweysihesar@yahoo.com.

On the other hand, regardless of the information value of management's forecasts, the company's information environment also affects its risk. Research has shown that information environments are related to the amount, type, and quality of disclosed information. The purpose of creating accounting information devices is to provide an environment that both makes information available and eliminates the risk of information errors. In companies where a higher level of confidential information is disclosed, the information environment of the company becomes stronger. Therefore, it is argued that in companies with a strong information environment, the management seeks to provide more information to the users, and that management's predictions can be used in this direction according to the management's goals. Thus, in strong information environments, by increasing the accuracy of information in forecasts, management increases the credibility of this information and reduces the company's risk (Kitagawa & Okuda, 2016).

Based on the above discussion, the aim of this research is to investigate the effect of information environments on the relationship between disclosure quality and unsystematic risk.

RESEARCH QUESTIONS OR HYPOTHESIS

According to the purpose of the research, the research hypotheses have been developed as follows:

First hypothesis: There is a positive and significant relationship between management forecasting error and unsystematic risk.

Second hypothesis: Strong (weak) information environments have a decreasing (increasing) moderating effect on the relationship between management forecasting error and unsystematic risk.

METHODS

The statistical population of the study consists of all companies listed on the Tehran Stock Exchange that were active in the stock exchange from the beginning of 2008 to the end of 2018. In selecting the companies, the following conditions were considered: to control the time effect and increase comparability, the end of the fiscal year of the studied companies should lead to the end of March each year; to homogenize the statistical population, companies did not change their financial year during the research

period; some listed companies, including banks and financial institutions such as investment companies, financial intermediaries, holding companies, banks, and leasing companies, which have different financial disclosures and structures of the company's governing principles, were excluded; to ensure companies' shares were fluid and for better comparison, companies should not have had a trading interval of more than three months; and the necessary data during the research period should have been fully available. A total of 86 companies that met the above conditions were selected to test the research hypotheses. After collecting the data, Excel software was used for summarizing and calculating. Then, the final analysis was performed using multivariate regression patterns in Eviews software.

RESULTS

The results of the hypothesis test showed that there is a positive and significant relationship between management forecasting error, net sales forecasting error, operating profit forecasting error, and net profit forecasting error with unsystematic risk. In general, the results show that the company's unsystematic risk increases as the disclosure quality decreases. Additionally, the good (weak) information environment has an inverse (direct) and significant effect on the relationship between management forecasting error, operating profit forecasting error, and net profit forecasting error with unsystematic risk. However, it does not have a significant effect on the relationship between net sales forecasting error and unsystematic risk. In general, the results show that weak information environments with increasing information asymmetry lead to an increase in management forecasting error and, as a result, a decrease in disclosure quality and an increase in unsystematic risk. But in strong information environments, by increasing the accuracy of information in forecasts, management increases the credibility of this information and reduces the company's risk.

DISCUSSION AND CONCLUSION

The results indicate that there is a positive and significant relationship between management forecasting errors, net sales forecasting errors, operating profit forecasting errors, and net profit forecasting errors with unsystematic risk. The relationship between these variables decreases (increases) in companies with a strong (weak) information environment. These findings are consistent with empirical evidence that

suggests the quality of financial reporting is linked to unsystematic risk trends. Since managers have access to more accurate information than individuals outside the company (Jensen & Meckling, 1976), they can minimize the company's risk through accurate and reliable forecasting. Improving the quality of financial reporting and information disclosure about firm performance reduces stock return volatility and risk (Rajgopal & Mohan, 2011).

Furthermore, the study found that larger (smaller) companies tend to have stronger (weaker) information environments. Weak information environments with increasing information asymmetry led to increased management forecasting errors, lower quality disclosure, and an increase in unsystematic risk. In contrast, strong information environments reduce information asymmetry and risk by increasing forecast accuracy.

Based on the results of the first hypothesis, it is recommended that managers use accurate and reliable forecasting to minimize information asymmetry and reduce risks. The results of the second hypothesis suggest that managers should minimize market punishment by increasing their skills and abilities to disclose information in a timely and accurate manner, thereby increasing the credibility of the information and reducing the company's risk. Inappropriate and weak information environments can lead to investor reluctance to participate in the capital market, prevent the optimal allocation of resources, increase the cost of capital for companies, and, in the worst-case scenario, lead to a market collapse. Therefore, strong information environments are crucial for reducing these risks.

Keywords: Disclosure Quality, Management Forecast Error, Idiosyncratic Risk, Information Environment, Principal Component Analysis.

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