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THE ROLE OF ADDITIONAL DISCLOSURE SOURCES IN RATIONALIZING INVESTOR DECISION IN EGYPT: A SUGGESTED FRAMEWORK

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ABSTRACT

This Paper provides a framework of additional disclosure sources including: management reports, financial analysts' reports, and business press. We categorize additional disclosure framework into four components: disclosure sources, disclosure index characteristics, disclosure consequences, and rationalizing investor decision. We suggest that additional disclosure may be achieved through the integration of the three sources of disclosure. In addition, we found that although the additional disclosure index seems to be an important factor; because of being subject to more control on managers and analysts, investors, in the Egyptian environment, neither fully comprehend its value nor depend on it. We found also that much of the prior researches ignore directing the management to follows the financial analysts reports. This leads to inaccurate forecasts, which, in turn, results in irrational investor decision. Prior researches also ignore the effect of additional disclosure nature that can be described as "the disclosure consequences of the current period influence chosen characteristics in subsequent periods". Implications for researches, educators, managers, investors, and regulators are provided.

Key words: Additional disclosure, information asymmetry, Bid ask spread, Rationalizing investor decision

1. INTRODUCTION

Lately companies have realized the importance of information to the financial statement users, especially after the collapse of numerous large companies and banks in the United States of America, such as: Enron, World Com, and Lehman Brothers Bank. Baily et al (2003) believe that Information is the life and soul of strong capital markets, and, therefore, the unavailability of information causes the capital markets to bottom out (1). To avoid providing misleading information to investors, a considerable need for disclosure, which makes available the information that helps increase that trust between the management and the financial statement users. In addition to bringing the accounting disclosure standard up to the fair disclosure which can be described as comprehensive. This requires depending on other sources of information other than what is required by the accounting standards, represented in financial reports and the accompanying footnotes. Other sources of accounting disclosure are the reports of the board of directors (management reports) about the competition faced by the enterprise, the reports made by the financial analyst, and business press. Such sources might help investors take rational investment decisions, especially when they have alternative investment opportunities.

Additional disclosure is a relatively recent concept. It is sometimes referred to by: informative disclosure, voluntary disclosure, educational disclosure, or cognitive disclosure. It aims at making a serious attempt to provide all participants in the capital markets with additional information from other sources other than what is required by the accounting standards.

The Financial Accounting Standard Board (FASB, 2000) describes “voluntary disclosures” as “information primarily outside of the financial statements that are not explicitly required by accounting rules or standards.” Recent guidelines provided by FASB have encouraged companies to make such disclosures in the management discussion and Analysis (MD&A) section of the annual reports (12). As such, voluntary disclosures involve disclosures in excess of the requirements and include accounting and other information that managers of a company deem relevant to the needs of various stakeholder groups (14).

Francis et al (2008) suggest that additional disclosure enhances firm value because companies appear more honest and caring about the world in which they exist. They find that additional disclosure, like regulated disclosure, lowers capital costs and increases credibility because of lessening asymmetry (7). Karolyi (1998) suggests that foreign firms that list in the United States decrease their cost of capital and reduce their overall risk through voluntary disclosure (10). According to Bothwell (2004), disclosure increases transparency and enhances self-regulation, avoiding scandals and future regulation (2). The World Resources Institute (2003) clarified that when a company adopts a voluntary (or additional) practice, the company accepts public expectations of corporate behaviour (17). Moreover Rodriguez & LeMaster (2007) suggest that additional disclosures would improve a firm’s position similarly to regulated disclosure (16).

To emphasize this, Zechman (2010) referred to the fact that without voluntary disclosure, the mandated reporting for a synthetic lease leaves outside users with minimal information and a limited ability to effectively capitalize the lease (18).

Langberg & Sivaramakrishnan (2010) indicated that credible voluntary disclosures of forward looking information by firms (e.g., of financial conditions, expectations regarding sales growth, competitive position and so forth) are presumably useful to market participants in making their investment decisions. Such disclosures often trigger scrutiny and analysis, and provide the lens through which investors and financial analysts view future actions taken by management. In turn, such disclosures can potentially benefit managers seeking feedback from financial markets (13).

In brief, additional disclosure of information might bring many benefits. It helps in providing a limitless number of users with plenty of information at the appropriate time. It can also help the users of financial statements and reports restore and analyze information in an easier way which will assist in taking appropriate decisions. Therefore, the additional disclosure of information can be defined as a display of the suitable additional information at the appropriate time through the reports of the management and financial analysts and business press, in a way that will give the reader an accurate image of the enterprise's conditions and help in making rational decisions.

The rest of this paper is organized as follows. Section (2) presents an overview of the suggested framework. This includes a summary of the major themes related to additional disclosure within the context of the four components of our framework namely: additional disclosure sources, characteristics, consequences, and rationalizing investor decision. Section (3) discusses the role of each source in rationalizing investor decision. Section (4) presents the conclusion.

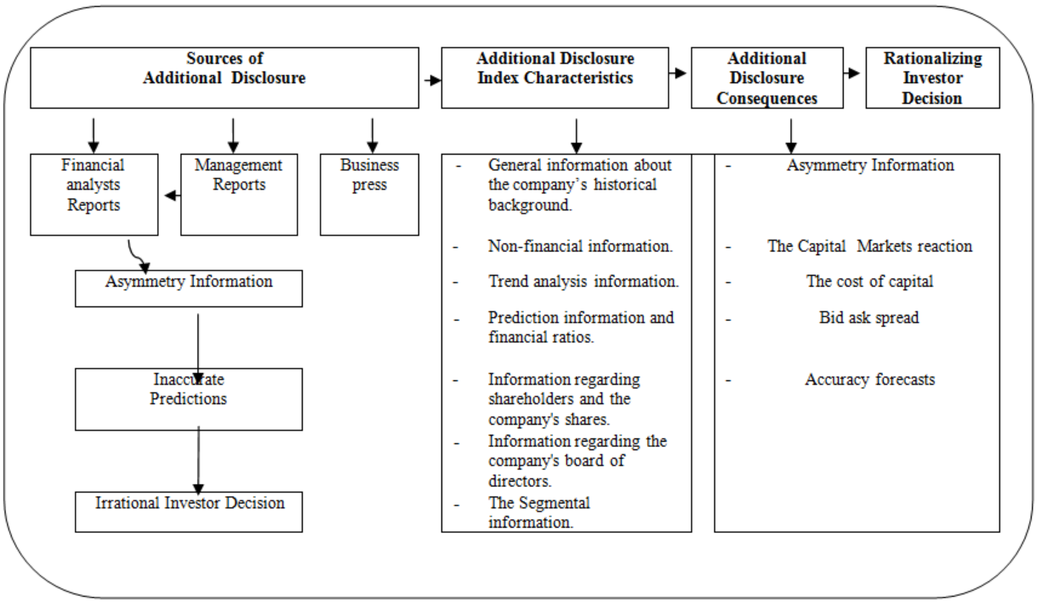
2. FRAMEWORK

Figure 1 presents a pictorial representation of the additional disclosure sources, disclosure index characteristics, disclosure consequence and rationalizing investor decision. We will discuss each component of the framework in details.

2.1. Disclosure Sources

Disclosure sources are those resources used to provide all the users' information needs to qualify them to take rational investment decisions with high certainty degree. Such sources include management reports, financial analysts reports and the business press. Each source is considered in details; to analyze the effect of each source on the environment of the capital markets.

Kothari et al (2009) suggest that disclosures by management, analysts, and news reporters differ on at least two dimensions. First, incentives facing management, analysts, and news reporters might differentially shade the contents of their disclosures or reports. In particular, management and investment analysts can have strong incentives to optimistically skew disclosures, whereas news reporters' incentives to be optimistic in their reports are muted. The capital markets are likely to weight disclosures according to the credibility of the source of the disclosure. That is, on average, in pricing stocks, the market is expected to filter out the bias and deemphasize noisy disclosures by the management, analysts, and news reporters. Second, news stories in the business press are likely to be timelier than analysts' reports (11).



The above figure shows the different components of the additional disclosure of information process. Each component contains several elements. The skewed arrow refers to the effect of the management directing the financial analysts in a way that leads to make irrational investor decisions.

Fig. 1. *A Framework for the Relationship Between Additional Disclosure Sources and Rationalizing Investor Decision*

2.1.1. Management Reports

The company's interest in disclosing the necessary accounting information has increased for making plans, establishing policies, and having tight control over the company's various activities.

Furthermore, investors and some other users strongly rely on the reports of the board of directors for the purpose of taking investment decisions and other decisions, because these reports are relatively highly trusted. This is because the management has the company's internal information that may not be available for outside parties. The Management also has detailed financial information of the past years as well as the current year that make it able to provide reasonably accurate information.

Hirst et al (2007) pointed out that management earnings forecasts are valuable tools for a firm to communicate its expectations to market participants. Such forecasts have the potential to inform investors, reduce information asymmetry and information risk, and decrease the firm's cost of capital (8). Mercer (2004) pointed that as with other voluntary disclosures, their informational value hinges on their credibility, or the extent to which the disclosures are believable to investors (15).

Furthermore, Cheng and Lo (2006) believe that managers will make disclosures only when such disclosures provide them with (net) private benefits. However, there is little evidence of a direct link between managers' private benefits and voluntary disclosure of corporate information (6).

Accordingly, we see that the more detailed the information provided by the management to serve the needs of the users of the financial statements, and with more integration among the management reports, the financial analysts reports and business press, the less asymmetric information and the more capability of managing the profits the company becomes.

2.1.2. Financial Analysts Reports

Due to the common asymmetric information phenomenon in the capital markets, investors who do not have access to the necessary information have two options: searching for collecting the required information or relying on the information intermediaries. Because the first option is difficult, the capital market's demand for the services provided by analysts, auditors and stock brokers has increased and the number of financial analysts has enormously increased.

Useful information can be provided through the role played by information intermediaries, such as: auditors, financial analysts and brokers. This information leads to the equality of all investors who have information and, therefore, are able to discover any dereliction of duty on the part of the management with regard to the misuse of resources.

Furthermore, the financial analysts are not only important to investors by providing information that serves their goals and decisions. They could be more important to the company as well if they cause capital to flow from investors to the enterprise in reaction to the provision of information through them, and, this would increase the company's desire to provide investors with better information as long as this will cause capital to flow to the company. Also, the relationship between financial analysts and the management of companies and investors boosts the efficiency of the capital markets and the rationalization of investor decisions because such relationship is examined and inspected by the capital markets organizations, financial organizations, and accounting and auditing organizations.

Kothari et al (2009) view that analysts are important information intermediaries in capital markets. They expend real resources on gathering information and producing research reports, analysts frequently repackage and retransmit available information from corporate disclosures and business press news stories in presenting in-depth analysis in their own reports (11).

Despite the support given to that source of the additional disclosure of information, there are many criticisms which complicate its role in solving the asymmetric information problem. Some of the most important criticisms are that turning to financial analysts increases the cost of information, and, consequently, a big number of dealers in the market withdraw, which causes the cash flow to decrease and the cost of capital to increase, and that the financial analysts motives may cause them, in a specific way, to tend to favor some parties over others.

2.1.3. Business Press

While it is desired to decrease the extent of the asymmetric information to its lowest levels, there appeared another source of the additional disclosure of information represented in the business press which aims at providing more accuracy and credibility information, and, therefore, it is highly accepted by the information users. Also, this source provides the information required for evaluating the economic conditions of the company and its competitive position.

Kothari et al (2009) indicate that news stories in the business press to be quite timely with an emphasis on factual reporting. News reporters and the business press typically do not have strong economic ties and relationships with individual firms. Moreover, each reporter reports on a large number of corporations as new developments take place with individual firms. Therefore, we expect news stories to have both credibility and timeliness and, hence, the contents of news stories are likely to be informative about the cost of capital (11).

Moreover, Bushee et al (2010) view that the business press is a real added value to an effective source of additional disclosure along with the other sources of disclosure represented in the reports of the management and financial analysts due to the numerous advantages of that source, like decreasing the phenomenon of asymmetric information of the company through enriching the company's information environment effectively by providing continuously renewable information which is useful to all participants in the capital markets. Also, that source is easily understood by investors with limited knowledge because information is displayed in various ways. Finally, that source plays a role in establishing highly accurate expectations that activate the capital markets (5).

Business press is also an effective information intermediary, it plays an informational role around firms' earnings announcements in a number of ways. First, the press facilitates dissemination of the firm's earnings release. Multiple news wire services generally disseminate brief summaries of the key points of the earnings announcement shortly after the firm releases it. The press also alerts investors to upcoming scheduled firm disclosures, such as the time of the conference call or an appearance by the chief executive officer (CEO) on television. Second, the press packages information together from multiple sources. News wires frequently update their reports of the earnings announcement by adding analyst forecast information, price information, and management forecast information as it becomes available. The press also often puts together lists of "hot stocks" during the day. Finally, the press creates new information (5).

2.2. Additional Disclosure Index Characteristics

By depending on the sources of the additional disclosure of information (reports of the board of directors and financial analysts and business press), an index of information can be created. This index is composed of seven groups including 66 information elements. Such as the index has been compiled by surveying the information mentioned in the financial reports of some Egyptian companies which are prepared by their boards of directors, the business press (monthly press release, the annual disclosure book of more than 50 companies which deal with the Egyptian capital Market) and the information deduced by the researchers from reading the reports of financial analysts. Furthermore, the contents of this list are in accordance with the results of the Egyptian studies with regarding disclosing information and its effect on improving the information environment.

The Additional Disclosure Index is composed of seven types of additional disclosure (see Appendix): (1) General information about the company's historical background (2) Non-financial information, including information about customers, employees, society service, and environment protection (3) Trend analysis information (4) Prediction information and financial ratios (5) Information regarding shareholders and the company shares (6) Information regarding the company's board of directors (7) The Segmental Information.

Botsan (1997) suggest that the comprehensiveness of the additional disclosure of any company could be measured through an index. This takes place by comparing the company's financial reports with the contents of that Index so as to determine the proportion of the additional disclosure of the company's information through dividing the amount of information the company discloses by the maximum information in disclosure index (4).

We view that the index includes information important to financial statement users, allowing them to determine the position of the companies included in the capital markets, in a way that would rational investor decisions (such as: purchasing, selling or keeping the shares of a specific company) based on the availability of information in the environment.

2.3. Disclosure Consequences

Disclosure Consequences refer to the outcomes associated with the additional disclosure, We organize our discussion in this section around those consequences as shown in Figure 1- namely, information asymmetry, stock market reaction, cost of capital, bid ask spread, and accuracy forecast.

2.3.1. Information Asymmetry

The additional disclosure sources do not allow some investors to possess private information. However, all investors in the market would have the same information and this decreases the information asymmetry. This would encourage current investors to increase their dealings in the market and drive new investors to the market, and, consequently, the volume of dealings and the market cash flow will increase.

2.3.2. Capital Markets Reaction

Efficiency is one more characteristic which the market will have as a result of the rapid provision of information from additional disclosure sources, especially through daily and monthly business press releases. Consequently, there won't be intervals between analyzing information and reaching specific results concerning the share's real value. Also, there won't be an interval between obtaining information and taking investor decision.

2.3.3. Cost of Capital

With the additional disclosure of information, information is fairly provided for investors in the market. Accordingly, the information risk faced by the investor decreases and this, in turn, would reduce the return the investor seeks. This would decrease the company's financing cost, and, as a result, the cost of capital will decrease.

2.3.4. Bid Ask Spread

The bid ask spread refers to the difference between the maximum demand and minimum supply of a stock. The Bid Ask Spread is considered one of the noticeable variables that express information asymmetry. If additional disclosure of information is unavailable, the management will possess private information and use it to make judgments and estimates of many issues, like choosing accounting policies and the resultant distrust of the parties, which have not got the information, in the rationality of such judgments and estimates. Therefore, those parties try to protect themselves from the management's actions by introducing lower prices which will cause the price range to increase.

Accordingly, we believe that by achieving the additional disclosure of information through its various sources, the information environment of the capital markets can be improved, where information is provided at the appropriate time before it loses its ability to impact decision making, and this will decrease the information asymmetry. Dealings between investors will go in the same direction and the price of each share will express its real value, and this would decrease the price range. Consequently, this would increase the investors' trust in the capital markets and make them take rational investor decisions.

2.3.5. Accuracy Forecasts

The capital markets information environment can be improved by achieving the additional disclosure of information. This will help provide a sufficient, comprehensive amount of information to establish predictions and make them more accurate. Such predictions spark the interest of all participants in the capital markets, especially investors who make decisions about selling, purchasing and keeping shares.

To ensure the benefits of the additional disclosure through its three sources, Kothari et al (2009) clarify that corporate disclosures, reports in the business press, and analysts' reports and discussion of corporate performance all enhance the information reflected in stock prices. That is, they reduce information asymmetry between the average investor and informed market participants, e.g., company management (11)**.** In addition Botosan and Plumlee (2002) suggest that a rich disclosure environment and low information asymmetry have many desirable consequences. These include the efficient allocation of resources in an economy, capital markets development, liquidity in the market, decreased cost of capital, lower return volatility, and high analyst forecast accuracy(3).

2.4. Rationalizing Investor Decision

The final output of our suggested framework, including the additional disclosure sources, is rationalizing the investor decision. This means achieving the investor's highest return, whether in the form of profit or an increase of the market price of shares at a specific risk rate or preventing a particular loss. Therefore, the rest of this paper clarifies the role of each source in rationalizing the investment decisions.

3. THE ROLE OF ADDITIONAL DISCLOSURE SOURCES IN RATIONLAIZING INVESTOR DECISION

3.1. The Management Reports Role in Rationalizing the Investor Decision

We view that it is possible to obtain the management's trustworthy and credible reports which have a positive impact on rationalizing the investment decisions through enhancing the management. The company's market value is determined according to the management services. Therefore, rational management will try to raise the company's market value because this directly benefits the management with regard to the employment contracts and other greater advantages, and, therefore, the management's market value will be increased. Undoubtedly, this will motivate the management to provide comprehensive and improved information reports which help increase the investors' confidence.

Furthermore, these reports are controlled by accounting and auditing organizations to make them more credible. Eventually, all this will raise the capital markets efficiency and would rationalize investment decisions. Also, this will help a double impact on enhancing the management as a reaction to the investors' increased trust (feedback). This is shown in the following figure.

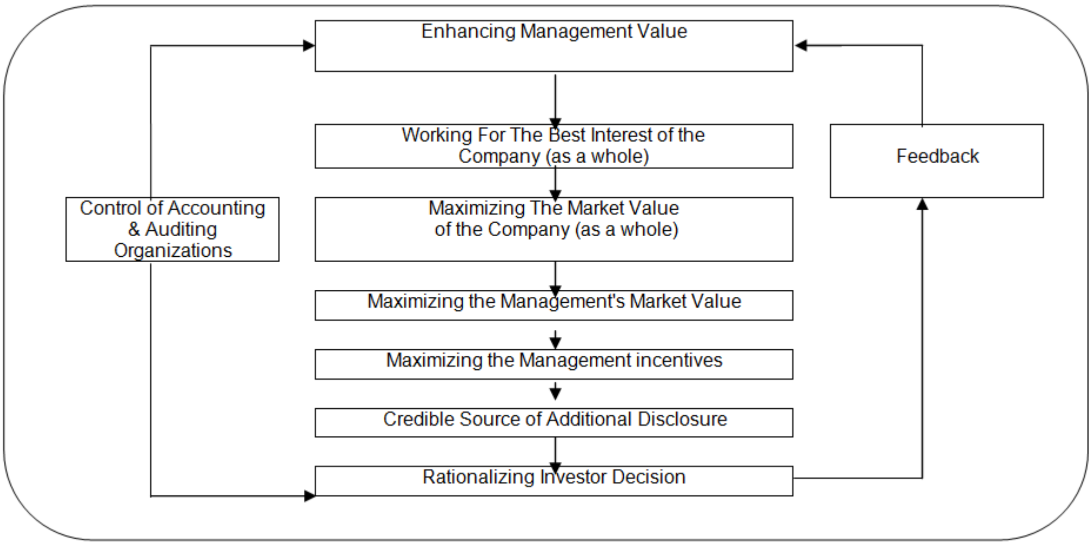


Fig. 2. *The Management Reports as an Effective Source of Additional Disclosure to Rationalize Investor Decision*

3.2. The Financial Analysts Reports Role in Rationalizing the Investor Decision

We expect that effective and credible reports of financial analysts (a source of additional disclosure) can be made, and such reports have an impact on rationalizing the investment decisions. This takes place by depending on many determinants that help in improving the financial analysts' reports. Each of these determinants is discussed individually.

- **The Financial analysts Experience & Effort:** the more experience the financial analysts have through the analyses they have conducted in the previous years, and the more effort they exert in acquiring information from different sources and analyzing it, the more accurate the provided reports are and the more investors trust these reports, in a way that helps them decision making.

- **The Company's Size:** It is one of the important determinants of the financial analysts' reports; because large companies are less vulnerable to earnings fluctuations and more stable in terms of growth and profitability. Therefore, large companies disclose more information than small companies, and this assists financial analysts in providing more accurate reports.

- **The Size of Financial Analysis Offices:** It is one of the important determinants of the information reports. The bigger the size of the financial analysis office, the more available resources and potentials which help analysts in using prediction samples more than an individual analyst. Eventually, this will result in the financial analysts having reports that give investors higher confidence.

- **The Management's Credible Reports:** It is one of the important determinants of the financial analysts reports; because the Management reports disclose more information. Moreover, such reports are subject to control which makes them a credible information source that won't affect the financial analysts' independence. As a result, the financial analysts can provide more credible and trustworthy reports for investors.

We would like to point out here that the management's directions for the financial analysts and providing them with the necessary information to deliver their reports might negatively affect the investment decisions. This was illustrated in figure (1) by the skewed arrow. Hutton (2002) emphasizes that one of the reasons for the collapse of Enron and World Com is because the management directs the analysts' expectations and predictions for the reports to include what the management desires, not its actual performance, and this causes the financial analysts reports to be less credible, and failure to provide trustworthy and useful for investors (9).

However, we expect that enhancing management through keeping it under the supervision of the accounting and auditing organizations as it has been previously illustrated in figure (2), its integration according to this form with the financial analysts as a source of disclosure may not affect the financial analyst's independence and would avoid bias. That also will not affect the financial analyst's reports. On the other hand, it would enable the financial analyst to carry out careful analysis which leads to rational investor decision.

The following figure shows how to put the financial analysts' reports into effect as a source of credible additional disclosure.

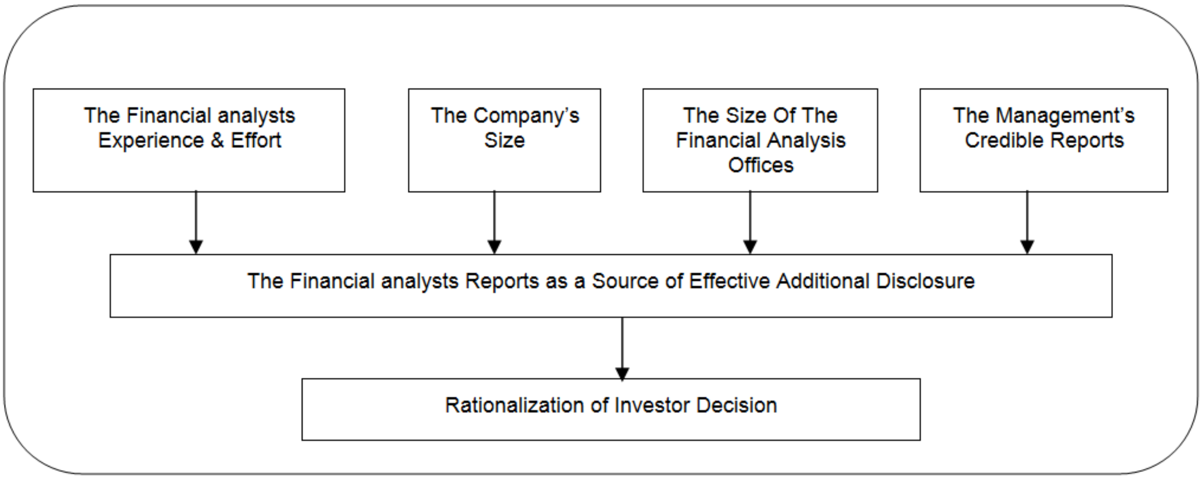


***Fig. 3.** Financial analysts Reports as an Effective Source of Additional Disclosure to Rationalize Investor Decision*

3.3. The Business Press Role in Rationalizing Investor Decision

We believe that effective and credible business press (a source of additional disclosure), positively affect the rationalization of investment decisions through a number of determinants as follows.

- **The Effort Made by the Business Press Preparers:** If more effort is exerted in obtaining information from different sources and analyzing it, this will increase the accuracy of the provided reports and the confidence of investors in a way that will be useful when taking decisions.

- **The Company's Performance:** The better the company performs by increasing its profits and cash flows, the less uncertainty surrounding the company. This will help the business press preparers have more potential reports for the company.

- **Listing on International Capital Markets:** Companies registered in international capital markets are subject to strict rules, which have to do with disclosure of information, and the international bodies' pressures. Therefore, more credible and trustworthy reports have to be prepared.

- **Governmental Bodies' Control:** The governmental bodies' control exercises pressure upon the reports preparers, and, therefore, more effort has to be made for providing accurate, objective and credible reports.

The following figure shows how to put the business press into effect as a credible source of additional disclosure

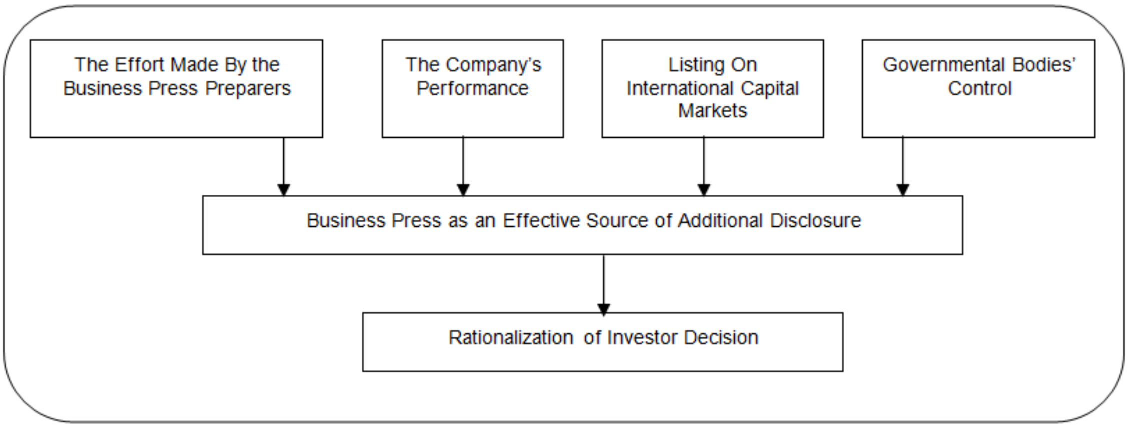


Fig. 4. *Business Press as an Effective Source of Additional Disclosure to Rationalize Investor Decision*

4. CONCLUSION

In this paper, we suggested a framework that demonstrates the role of additional disclosure in rationalizing investor decisions. This framework categorizes additional disclosure process into four components- disclosure sources, additional disclosure index characteristics, disclosure consequences, and rationalizing investor decision. The additional disclosure sources component refers to management reports, financial analysts report, and business press. The additional disclosure index characteristics components refer to specific features of disclosure index that influence capital markets to provide enriching information environment. The additional disclosure consequences refer to the outcomes resulting from additional disclosure. The rationalization of investor decision refers to investor capability to achieve the best return as profit shape, or increase the stock market price with specific level of risk.

Three important conclusions emerge through this framework. First, although the additional disclosure index seems to be an important factor; because of being subject to more control on managers and analysts, investors, in the Egyptian environment, neither fully comprehend its value nor depend on it. Second, our study highlights that additional disclosure focuses on the main effect of additional disclosure sources or additional disclosure index characteristics on additional disclosure consequences. The study of interactions between and among additional disclosure sources, index characteristics, consequences, and rationalizing investor decision appears to be a fruitful area for further work. Third, the additional disclosure presents a number of opportunities for future research.

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APPENDIX

Part 1: Historical Background Information

1. Brief history of the company
2. Objects and financial, social, production and marketing policies of company
3. The company's current products
4. The company’s current share of product markets
5. Factors that affect the company’s business activity
6. Historical summary of the financial ratios
7. Historical summary of the financial data
8. Historical summary of the employment cost
9. The book value of the temporarily non-operating fixed assets
10. The book value of consumed operating assets
11. The book value of unused and maintained assets
12. The book value of technically expired assets
13. The company’s current competitive situation
14. Risks faced by the company and its policy to lower them

Part 2: Non-Financial Information

1. Customer satisfaction
2. Employee satisfaction
3. The company’s efforts in supporting the society and protecting the environment
4. Human resources and management development investments
5. Investments in other intangible assets research and development
6. The extent of creation and creativity with regard to the company’s products
7. Health care provision for the company’s employees
8. The nature of training courses and how beneficial they are
9. Improvement plans and work conditions
10. Reasons for the changes in the number of employees and sectors

Part 3: Trend Analysis Information

1. The sales trend for the last 5 years
2. The net operating income trend for the last 5 years
3. The cost of capital for the last 5 years
4. The share prices trend for the last 5 years
5. The number of research and development employees for the last 5 years
6. The sums of money spent on research and development for the last 5 years
7. Comparative analytical summary of the change of expenditure on research and development

Part 4: Prediction information and financial ratios

1. Profitability ratio
2. Cash flow ratio
3. Ratios of liquidity
4. Sales prediction
5. Profits prediction
6. Cash flow prediction
7. Share profitability prediction
8. Prediction of the future number of employees

Part 5: Information Regarding Shareholders and Company's Shares

1. The number of shareholders
2. Types of shareholders
3. Number of shares for each type of shareholders
4. Ratio of contribution to the company's capital
5. The largest shareholders
6. The volume and value of shares of the large shareholders
7. The share's market value
8. The development of the share's market value
9. Historical summary of the capital and the share's par value and the number of values
10. Development of distributions of shares and ratios of distributions
11. Earnings per share according to the net income components

Part 6: Information Regarding the Company's Board of Directors

1. Names of the members of board of directors
2. Academic and professional qualifications of the members of board of directors
3. Job responsibilities of the members of board of directors
4. Ages of the members of board of directors

Part 7: Segmental Information

1. Classifying income according to customers and its movement
2. Classifying income according to the lines of action and its movement
3. Classifying income according to the geographical sector and its movement
4. Classifying expenditures according to customers and their movement
5. Classifying expenditures according to the lines of action and their movement
6. Classifying expenditures according to the geographical sector and their movement
7. Classifying profit according to customers and its movement
8. Classifying profit according to the lines of action and its movement
9. Classifying profit according to the geographical sector and its movement
10. Classifying production according to customers and its movement
11. Classifying production according to the lines of action and its movement
12. Classifying production according to the geographical sector and its movement