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# THE IMPACT OF VOLUNTARY DISCLOSURE ON SMEs IN DEVELOPING COUNTRIES

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**Abstract**

*The main objective of financial reporting is the disclosure of financial information within the framework of Generally Accepted Accounting Principles (GAAP). This paper deals with voluntary disclosure, its importance, and its impact on Small and Medium Enterprises (SMEs), whereas the voluntary disclosure can affect on the company and its current or future performance negatively or positively. The researchers analyze statistically the impact of voluntary disclosure on the SMEs in developing countries by using Fuzzy Logic tools to analyze the degree of impact for five main perspectives (Cost Situation, Accounting System, Business Strategy, Corporate Governance, and Capital Market). The researchers conclude to many important results which will help the SMEs in developing countries to make a good decisions in voluntarily disclosing about their information. The researchers also submit a proposed framework for measuring the impact of the voluntary disclosure on SMEs, which will contribute to rationalize the decision-making by the management of company.*

**Keywords:** Voluntary Disclosure, SME, Fuzzy Logic



## Introduction

Small and Medium Enterprises (SMEs) are enterprises which act a very important role in the economy of many countries, and SMEs are essential components of the economy in developing countries. In order to succeed, it is very important that developing countries' SMEs be developed and evaluated many accounting tools to improve the decision making.

Voluntary disclosure is considered a useful tool to increase the trust of public and to enhance the relationship between the company and customers, but voluntary disclosure has many disadvantages and negative effects, for that the good decision maker must choose the best ways to disclose.

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## Voluntary Disclosure

### 1. The Concept of Voluntary Disclosure:

An accounting disclosure is a statement released by a company, business, or corporation that identifies the financial strategies that are being used and reveals things like costs and profits for a certain calendar period. The main purpose of this sort of document is to inform both current and potential investors of the accounting strategies and methods used. These financial statements include, but are not limited to, the balance sheet, the statement of cash flows, the income statement, and the statement of stockholders' equity [1].

Voluntary disclosure is the provision of information by a company's management beyond requirements such as generally accepted accounting principles and Securities and Exchange Commission rules Manuscript requirements [2], where the information is believed to be relevant to the decision-making of users of the company's annual reports [3].

Voluntary disclosure is carried out by many companies, although the extent and type of voluntary disclosure differs by geographic region, industry, and company size[4], The extent of voluntary disclosure is also affected by the firm's corporate governance structure and ownership structure, in particular, research has found that top executives have a significant influence on their firms' voluntary disclosures, and that managers have unique disclosure styles related to their personal backgrounds including their career paths and military experience[5].

Therefore, voluntary disclosure, in contrast to mandatory disclosure, relies completely in managements hands. They are the ones who decide what, when and how much to publish. They have a full control over what will be known to the public and have to decide what would be the best option for their firm.

### 2. The Types of Voluntary Disclosure:

The types of voluntary disclosure can be classified into six categories according to their information [6]:

1. Business Data: Voluntary disclosure of business data usually relates to publish internal operating data and performance measurements which are used by the management to drive the business.
2. Management's analysis of business data: If the managers decide to disclose their private analysis, they usually should focus on explaining the circumstances for changes in the operating and performance related data also focusing on the identification of past effects and trends.
3. Forward-looking information: Regarding forward-looking information managers usually collect data about future possible opportunities and upcoming risks, their plans involving success factors and many comparisons with past performances, its affects on the future and how the past future plans have been well predicted.
4. Information about management and shareholders: Detailed data about firm's directors, management, biggest shareholders and relationships within the company could make the stakeholders closer to the business and therefore be beneficial for its interest.

Despite the fact that this is a useful data most of this information is already required in mandatory statements.

5. Background about the company: Making stakeholders know more about firm's activity would bring positive effects on company's activity. Managers should share broad objectives, mission and vision statements, strategies, and influence on the industry etc.
6. Information about intangible assets: Management should put high effort into explaining intangible assets of the company, especially because of the fact that accounting standards usually do not recognize them. Mandatory information does not take into account intangible aspects, and therefore the value of the company is usually lower.

**3. Theories Explaining Voluntary Disclosures Practices :**

Several theories have been found through the literature to explain voluntary disclosure practices, including agency theory, signalling theory, capital need theory, and legitimacy theory.

*1. Agency Theory*

Agency theory can be defined as “a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent "[7], according to companies' perspectives, the agents correspond to managers, whereas principles correspond to shareholders.

So the agency cost is the summation of different types of costs such as the monitoring cost, the bonding cost, and the residual loss, as shown in figure 1.

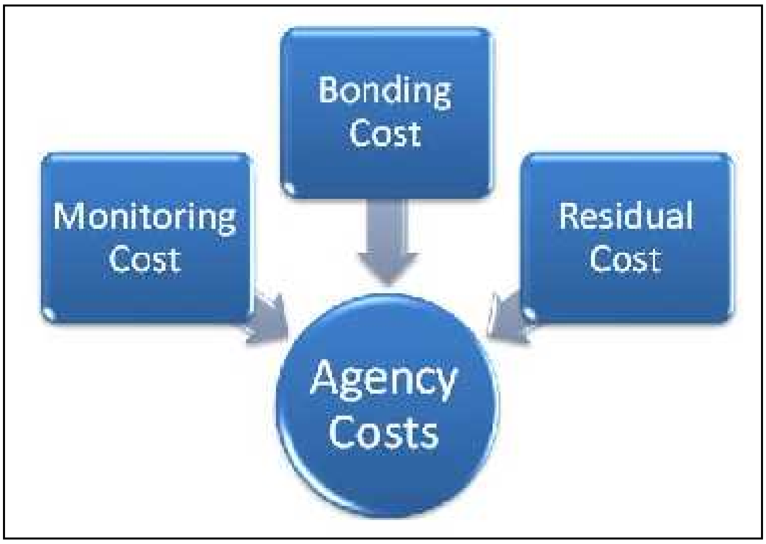


**Fig.1: The components of agency cost**

Agency costs are generated from the assumption that the two parties, agents and principals, have different interests, for that the agency cost can consist from the following [8]:

1. Monitoring costs which are paid by the principals, shareholders, to limit the agents' aberrant activities.
2. Bonding costs which are paid by the agents, managers, to guarantee that no harm of the principal's interests will result from their decisions and actions.
3. Residual loss which stems when decisions of the agents diverge from decisions that would maximize the principal's welfare.

Voluntary disclosure plays a big role to mitigate the agency problem, where managers disclose more voluntary information reducing the agency costs, and also to convince the external users that managers are acting in an optimal way [9].

*2. Signalling Theory*

The signalling theory was originally developed to clarify the information asymmetry in the labor market, also it has been used to explain voluntary disclosure in corporate reporting. As a result of the information asymmetry problem, companies signal certain information to investors to show that they are better than other companies in the market for the purpose of attracting investments and enhancing a favorable reputation [10] .

Voluntary disclosure is one of the signalling tools, where companies would disclose more information than the mandatory ones required by laws and regulations in order to signal that they are better.

*3. Capital Need Theory*

The capital need theory suggests that voluntary disclosure helps in achieving a company's need to raise capital at a low cost.

The competition for capital leads to increase voluntary disclosure. The rationale beyond this is the fact that "a company's cost of capital is believed to include a premium for investors' uncertainty about the adequacy and accuracy of the information available about the company.", therefore, reduction in a company's cost of capital is achieved when investors are able to interpret the company's economic prospects through voluntary disclosure [11].

The relationship between voluntary disclosure and cost of capital was thought to be a positive relationship; the higher the information disclosures, the lower the cost of capital. However, many researchers highlighted that certain types of disclosure might have the opposite effect [12].

*4. Legitimacy theory*

The legitimacy theory assumes that a company has no right to exist unless its values are being perceived as matching with that of the society at large where it operates [13]. Accordingly, the idea of the legitimacy theory resembles a social contract between the company and the society.

Since the objective of accounting is providing users with information that help in decision-making, i.e., satisfy social interests, the theory has been integrated in accounting studies, and management is forced to disclose information that would change the external users' opinion about their company, in addition the annual report has been detected as an important source of legitimation [7].

Legitimization can occur both through mandatory disclosures, and voluntary disclosures provided in other sections of the annual report.

## 4. Determinants of voluntary disclosure

Many Scholars and researchers have assembled the factors affecting the provision of and need for voluntary disclosure, they categorize the factors affecting managers' decisions to voluntarily disclose information among motivations and constraints.

*1. The Motivations*

Motivations to voluntary disclosure include [7]:

- Capital markets transactions / information asymmetry
- Corporate control contest
- Stock compensation
- Increased analyst coverage
- Management talent signalling
- Limitations of mandatory disclosure

*2. The Constraints*

Constraints on voluntary disclosure include [14]:

- Disclosure precedent
- Proprietary costs
- Agency costs
- Political costs

Litigation can be considered as a motivation to increase disclosure or a constraint against disclosure as following [8],[14] :

- Voluntary Disclosure as Motivation: managers are encouraged to increase voluntary disclosure not to be subjected to legal actions against them resulting from untimely or inadequate disclosures. In addition, managers will give due care to disclosing more information, especially bad news to limit the threat of litigation.
- Voluntary Disclosure as Constraint: managers may reduce voluntary disclosures of forward looking information as a result of litigation, especially if managers face the risk of being penalized against their forecasts.

## 5. The Potential Effects of Voluntary Disclosure on Company:

Voluntary disclosure is likely to have significant impacts on company. In this paper the main effects are discussed as following [15]:

1. Cost Situation: Increased voluntary disclosure is likely to have a major impact on both the quantity and quality of publicly available information. It is likely to lower the cost of capital, to improve communication with analysts, to decrease stock price, and to have benefits from the perspective of both lenders and trade creditors, but it is important to realize that increased disclosure also places a greater cost burden in both preparation and, where appropriate, audit costs, so the benefits outlined above are likely to come at a fairly high price.
2. Accounting System: increased voluntary disclosure is that information generated from internally oriented information systems may now be made publicly available. That's why increased disclosure is likely to result in increased convergence between the financial and management accounting systems (MASs).
3. Business Strategy: Increased disclosure will most likely reduce a company's competitive advantage simply because additional information is revealed to competitors. What's less obvious, though, is increased disclosure may also increase the risk of class-action lawsuits. In particular, because forecasting is such a hazardous business, management's incorrect predictions issued in good faith may expose the company to potentially serious legal risks .
4. Corporate Governance: While the Sarbanes-Oxley Act (and other legislation/Securities & Exchange Commission requirements) will lead to an increase in the level of available information, any management team that goes beyond the extent of legal requirements by releasing meaningful additional information on a voluntary basis is likely to significantly enhance its credibility among investors. In this context, it is very important to remember that honest reporting about negative experiences is likely to enhance credibility . In addition, revealing information about well-thought-out strategic plans should help investors gain a better understanding of management's intentions as well as comprehend the firm's true value-creating potential. In addition, it is well established in the psychology literature that people perform better when they have challenging but attainable targets, so by publicly committing themselves to achieve published targets, management may have a better chance of increasing the commitment of all employees.
5. Capital Market: Improved disclosure is likely to lead to improvements in shareholders' capital-allocation decisions as well as their assessment of risk-adjusted returns. Hence, from a macroeconomic perspective, increased disclosure should lead to improvements in the market's role as a capital allocation mechanism. In addition, increased knowledge about the challenges and opportunities facing firms may also lead to investors taking a longer-term perspective on their investments. Any developments in this area should both reduce stock price volatility and lead to greater capital market efficiency. There is also, however, a risk that increased disclosures may lead to greater information overload from an investor perspective.

The summarized potential effects of voluntary disclosure can be more clear in figure (2) below.

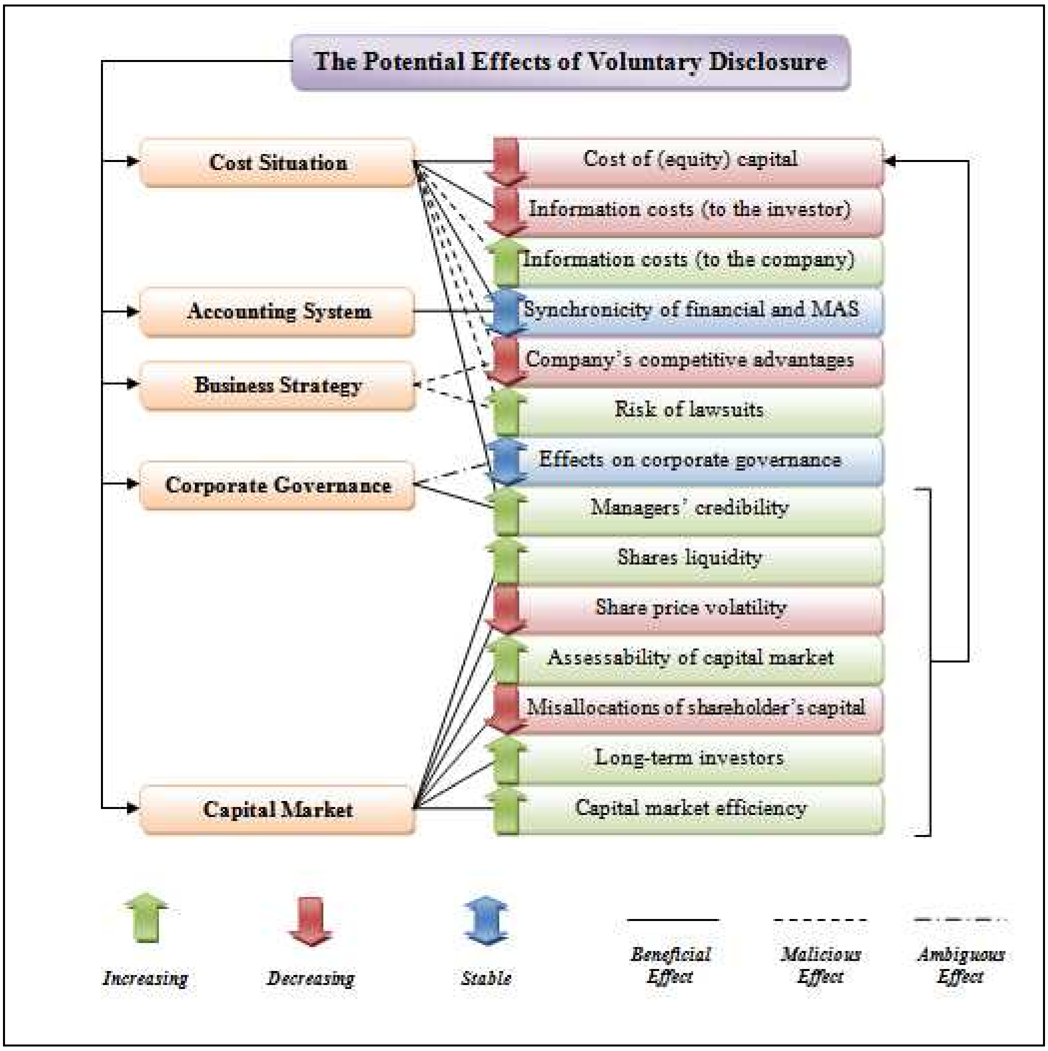


**Fig.2: The Potential Effects of Voluntary Disclosure on Company**

## The Analysis of Voluntary Disclosure on SMEs in Developing Countries

### 1. Small and Medium Enterprises:

Small and Medium Enterprises (SMEs) constitute a large number of establishments in most developed economies around the world. On average, this sector comprises more than 90 per cent of the total number of businesses in developed countries.

That might be anticipated that SMEs will contribute various advantages for these countries. Many scholars highlighted the advantages of SMEs that are generally accepted worldwide as including [16]:

- Engine of growth: SMEs contribute to the growth by being the largest provider of employment and as a source of technological innovation and new products.

- Essential for a competitive and efficient market: A large number of SMEs creates competitive market pressure. This sector also plays a major role in removing regional and sector imbalances in the economy and as subcontractors in the downsizing, privatization and restructuring of large companies.
- Critical for poverty reduction: SMEs play a particularly important role in developing countries where poverty is most severe. SMEs are sometimes the only source of employment in poor regions and rural areas and this sector is the only source of income for many poor.

## 2. The Analysis of Potential Effects of Voluntary Disclosure on SMEs in Developing Countries:

To analyze the potential effects of voluntary disclosure on SMEs in developing countries, 60 questionnaires were prepared by the researchers and distributed to a sample of random managers and owners in 30 SMEs in Iraq as a developing country.

The questionnaire consists of 5 perspectives with multi indictors for each one of them, according to the potential effects model in the previous chapter, and the researchers processed the data of the questionnaires and analyzed them by Fuzzy logic tools and using MatLab 10 to calculate the results.

## 3. The Results:

According to the analyzing of 60 questionnaires, many effects appear clearly, negative and positive. Table 1 shows the final results of the effects of voluntary disclosure in SMEs.

**Table 1: The Results of Analyzing the Questionnaires**

| The Perspective | The Indicator | Relative Importance | The effect | |
|---|---|---|---|---|
| | | | Indicator | Perspective |
| Cost Situation (CS) | Cost of (equity) capital – $CS_1$ | 25% | 0.163 | 0.0629 |
| | Information costs (to the investors) – $CS_2$ | | 0.135 | |
| | Information costs (to the company) – $CS_3$ | | -0.153 | |
| | Synchronicity of financial and Management Accounting System – $CS_4$ | | 0.180 | |
| | Company's competitive advantages – $CS_5$ | | -0.138 | |
| | Risk of lawsuits – $CS_6$ | | -0.183 | |
| | Managers' credibility – $CS_7$ | | 0.120 | |
| Accounting System (AS) | Synchronicity of financial and Management Accounting System – $AS_1$ | 10% | 0.039 | 0.1390 |
| Business Strategy (BS) | Company's competitive advantages – $BS_1$ | 15% | -0.104 | -0.0199 |
| | Risk of lawsuits – $BS_2$ | | -0.117 | |
| Corporate Governance (CG) | Effects on corporate governance – $CG_1$ | 20% | 0.081 | 0.1395 |
| | Managers' credibility – $CG_2$ | | 0.096 | |
| Capital Market | Shares liquidity – $CM_1$ | 30% | 0.087 | 0.0710 |
| | Share price volatility – $CM_2$ | | 0.114 | |

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| | | | | |
|---|---|---|---|---|
| **(CM)** | Assessability of capital market – $CM_3$ | | 0.177 | |
| | Misallocations of shareholder's capital – $CM_4$ | | 0.114 | |
| | Long-term investors – $CM_5$ | | 0.081 | |
| | Capital market efficiency – $CM_6$ | | 0.183 | |

## 4. Results Discussion:

- Cost Situation (CS): The most influential indicator in the cost situation perspective on voluntary disclosure is *Synchronicity of financial and Management Accounting System – $CS_4$* (0.180), and the less influential one is *Risk of lawsuits – $CS_6$* (- 0.183), Figure 3 shows the different effects of indicators of cost situation perspective on voluntary disclosure in company.

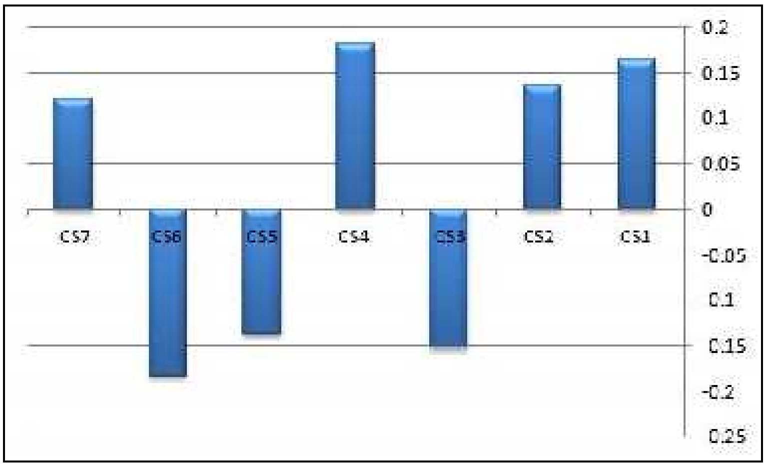


**Fig.2: The Different Effects of Cost Situation Perspective's Indicators**

- Accounting System (AS): There is only one indicator in accounting system perspective, this indicator is *Synchronicity of financial and Management Accounting System – $AS_1$* (0.039), it has good and positive effect on voluntary disclosure in company.

- Business Strategy (BS): The indicator *Company's competitive advantages – $BS_1$* (-0.104) effects on company more than the indicator *Risk of lawsuits – $BS_2$* (-0.117), but both of them are negative, as shown in figure 3.

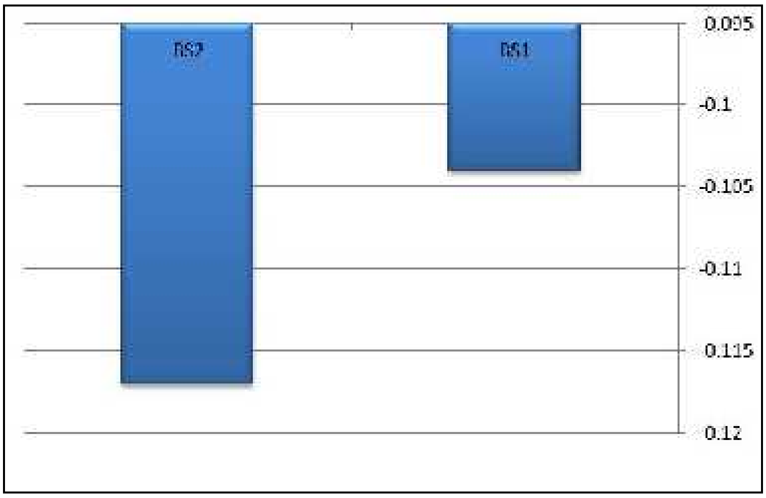


**Fig.3: The Different Effects of Business Strategy Perspective's Indicators**

- Corporate Governance (CG): The indicator *Managers' credibility – $CG_2$* (0.096) effects on company more than the indicator *Effects on corporate governance – $CG_1$* (0.081), and both of them are positive, as shown in figure 4.

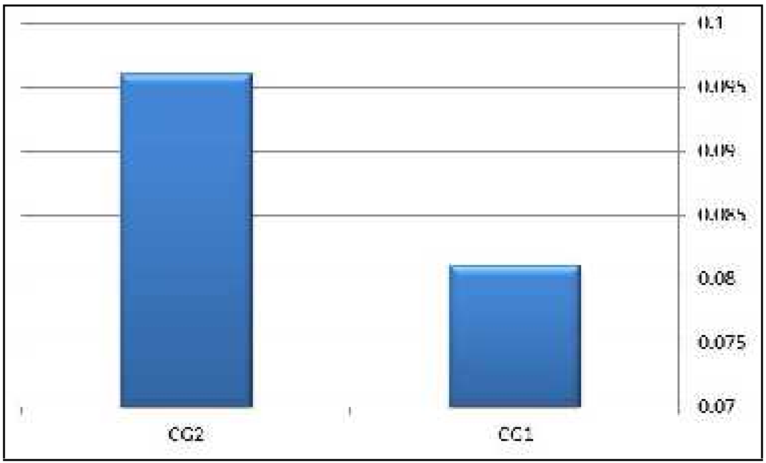


**Fig.4: The Different Effects of Corporate Governance Perspective's Indicators**

- Capital Market (CM): The most influential indicator in the capital market situation perspective on voluntary disclosure is *Capital market efficiency – $CM_6$* (0.183), and the less influential one is *Long-term investors – $CM_5$* (0.081), Figure 5 shows the different effects of indicators of capital market perspective on voluntary disclosure in company.

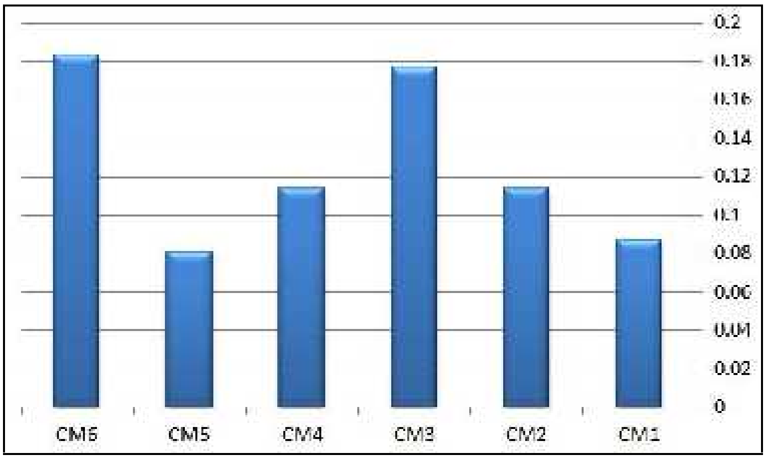


**Fig.5: The Different Effects of Capital Market Perspective's Indicators**

Finally, voluntary disclosure effects on SMEs in developing countries positively as average, but this effect differs from perspective to another according to their relative importance and the effect of their indicators. Figure 6 shows the effects of voluntary disclosure on SMEs.

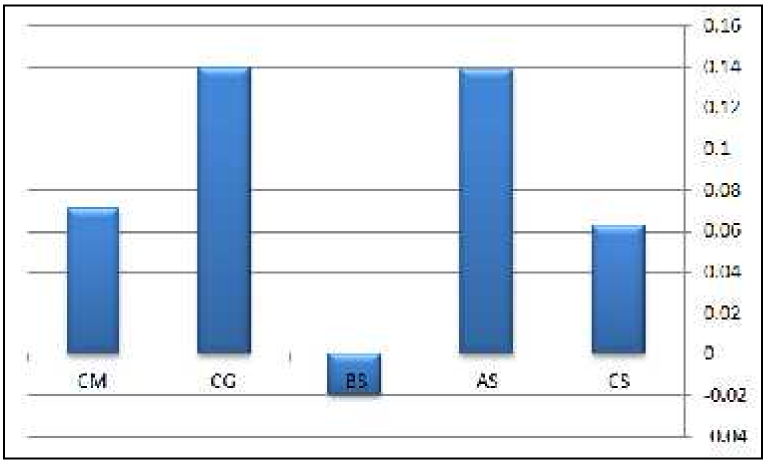


**Fig.4: The Effects of Voluntary Disclosure on SMEs in Developing Countries**

## Conclusions

According to the previous results, the voluntary disclosure can affect on SMEs by several perspectives which are cost situation, accounting system, business strategy, corporate governance, and capital market.

All of These perspectives affect positively, except business strategy which affects negatively, but the effects of voluntary disclosure on SMEs in developing countries is positive, the positive effect can be increased more and more by dealing with the indicators of the voluntary disclosure's perspectives.

Measuring and evaluating the perspectives of voluntary disclosure and their indicators can help the managers to make good decision for their SMEs.

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