Journal of Accounting and Social Interests "Scientific Journal"

Alzahra University- Faculty of Social Sciences and Economics
Accounting and Social Interests, VOL. 14, NO. 1, Spring 2024, Pages 19-22

The Effect of Business Strategy on Risk Disclosure[1]

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Received: 2023/09/07
Accepted: 2023/12/07

Research Paper

INTRODUCTION

Risk disclosure has gained substantial attention from regulators, investors, academics, and other stakeholders in recent years. With increased interest, investors and regulators have raised concerns about the current risk reporting practices. Risk disclosures have been criticized for being lengthy (Beatty et al, 2019) and too general and generic. There seems to be a certain consensus that risk disclosure needs to improve. The first step towards better risk disclosure is to fully understand risk disclosure. Risk is one of the important elements for all companies, every company is exposed to various risks (financial and non-financial) that can influence the business unit's operations and environment, which strongly affects the business unit's activity. Therefore, in the current research, the effectiveness of the company's business strategy on the disclosure of information related to risk in annual reports has been examined. We add to the discussion of determinants of risk disclosure beyond firm fundamentals by investigating whether a firm’s business strategy influences how much, what, and how the firm reveals information on its risk exposure in the annual report.

There are several reasons for this. First, firms adopting a prospector strategy have a business model that is typically characterized by more uncertainty. In

1. DOI: 10.22051/JAASCI.2023.44674.1795

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addition, prospectors engage in risky projects. Choosing a certain business strategy leads to higher risk exposure. The business strategy is a part of the risk profile of firms. A higher risk level implies higher information asymmetry among investors. According to agency theory, reporting and informing stakeholders about the risk factors in the annual report can reduce agency costs and information asymmetry between managers and shareholders (Habib, Ranasinghe & Perera, 2023). Compared to defender firms, prospector firms might also be exposed to greater public visibility. According to legitimacy theory, informing about risks helps stakeholders evaluate potential litigation risks and reputational risks. To prevent future negative, prospector firms signal legitimacy by immediately disclosing their risks and not withholding negative information. Second, according to organizational theory, prospectors reveal more voluntary information. Third, firms face a trade-off between the costs and benefits of reporting private risk information; by revealing too little information, firms could appear to have poor risk management; by revealing too much information, firms risk giving away valuable information to competitors. This is particularly true for prospectors. Prospectors rely more on external financing and should thus disclose more information to demonstrate transparency to existing and potential future stakeholders. Our findings seem to provide evidence that, for prospectors, the benefits outweigh the costs; that is, for prospectors, it is more valuable to engage in extensive risk disclosure than to reveal little information (Weber & Müßig, 2022). Overall, our results suggest that a firm’s business strategy is an important attribute that explains the firm’s risk disclosure behavior in recent years, the concept of business strategy has been given considerable attention by financial researchers, because business strategy is one of the factors that determine the amount of information disclosure related to risk, and according to organizational theory, the type of strategy chosen it is related to the motivation of companies to disclose information. Organizational theory provides a framework to understand how and how to disclose information, which can help to understand information disclosure by knowing the type of business strategy chosen by the company. Therefore, business strategy is one of the determining and effective factors in risk disclosure and reporting.

MATERIALS AND METHODS

In terms of classification based on the objective, the current research is of the type of applied research, the results of which can be used to inform policymakers to improve performance. The purpose of applied research is to develop applied and practical knowledge in a specific field. In addition, this research is in the correlation research group. Data were collected from companies listed on the Tehran stock exchange for a period of five years (2017–2021). Finally, the data of 69 companies were selected for analysis by systematic elimination method. the data of this research were studied after extracting and collecting in Excel using Eviews, version 10 Stata software version 15, and r software.

RESULTS AND DISCUSSION

Risk disclosure has been criticized for its lack of clear language, lack of specificity, and bias towards positive information.to improve risk disclosure, and the first step is to better understand what drives firms to report their risk factors. This study contributes to this discussion by analyzing whether a firm's business strategy influences its risk disclosure behavior. The findings of our study suggest that business strategy is a determinant of risk disclosure. The results of the hypothesis test have shown that there is a significant and positive relationship between aggressive strategy and risk disclosure. This shows that the business strategy (aggressive strategy) is effective in the behavior and the level of risk disclosure; therefore, companies with an aggressive strategy disclose risk information to a greater extent than companies with a defensive strategy in their annual reports. Other research findings have shown that there is a significant and negative relationship between defensive strategy and risk exposure. This shows that the business strategy (defensive strategy) is effective in the behavior and the level of risk disclosure; therefore, companies with a defensive strategy disclose risk information to a lesser extent than companies with an aggressive strategy in their annual reports

CONCLUSION

Our study further shows that the business strategy influences what and how firms report risks. According to the results of the research, since the type of strategy chosen by companies has an impact on the level of risk disclosure; as a result, investors can consider the business strategy when investing and form a more suitable portfolio. On the other hand, the findings will help investors and financial analysts adjust their proposals and decisions regarding stock transactions according to the impact of the chosen strategy on risk disclosure. Also, the results showed that aggressive companies disclose more risk, which leads to the reduction of information asymmetry in these companies, and

ultimately the information risk is lower, and it is the opposite for defensive companies. Also, according to the results of the research, it is suggested the policy-making, executive, legislative, and regulatory organizations adopt a structure so that the companies, especially the defense companies, submit reports. Financial along with risk disclosure requires to increase in the quality of financial reporting and optimal decisions for investors and shareholders.

Keywords: Risk disclosure, Business Strategy, Content analysis.

JEL Classification: M41, G32.

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