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The impact of profitability ratios on the disclosure level of information in Tehran Stock Exchange companies

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ABSTRACT

The main role of financial reporting is transferring information to outsiders in a credible manner, which it is realized by high quality disclosure of financial information. We investigate the relationship between information disclosure with profitability ratios as return on assets, return on equity, return on sales and dividend payout. Also panel data techniques and Binary Logit econometric model has been used in the period of 2008-2012. The results show that there is no significant relationship between information disclosure with return on equity and dividend payout, but there is a significant relationship with return on assets and return on sales.

1. Introduction

Increasing the development of the productive and trading enterprises is the most important feature of our age. One consequence of the evolution of accounting is using financial ratios that emerged in the late nineteenth century to assess and analyze the performance of financial statements. Accounting is the most important information in assessing the performance and it has been the basic principle in all criteria and principles. One of the types of analysis is analysis of financial ratios that is a kind of performance evaluation that its basis is dependent completely on the financial statements, including balance sheet, income statement and cash flow statements. Transparent comparable financial information is the key element for accountability and conscious economic decision making. Capital owners, creditors and other users need relevant financial information to make decisions in area of buying, selling and maintaining stocks, granting loans and other important economic decisions. Financial information of companies affects the investors' decisions and Investment decisions of investors depend on the presence of proper financial reporting. Financial reporting discloses the allocation of capital resources and the profitability of a commercial company, so full disclosure of financial information are necessary for financial statements users, and the lack of full disclosure in the financial statements will mislead them. It is obvious that the disclosure as one of the accounting principles, explains all important and relevant facts related to the events and commercial activities. Adequate disclosure, appropriate disclosure and full disclosure are the terms have been used to describe the disclosure in accounting and auditing books and articles, but the most common theory about the disclosure, is the adequate disclosure that indicates the minimum required disclosure. Appropriate disclosure indicates equal treatment with all potential users of the financial information. Full disclosure reveals a complete vision of the entity's activities and financial events. However, it is necessary to adequately disclosed financial statements, but it should not contain excessive unimportant information, because It may draw the attention of financial statements users to detailed and trivial information and thus important events and activities will be ignored . American Accounting Association considered disclosure, the flow of information of specific territory to the realm of public. The term of disclosure is one of the fundamental principles in accounting that explains all important and relevant facts related to the commercial activities. In some countries, entities are not willing to disclose adequately without legal obligation. The new law of the securities market passed in the Persian date Azar 2004 required adequate disclosure and transparency in primary and secondary markets.

In this study, that is "The relationship between profitability ratios with the level of disclosure in the financial statements of Tehran Stock Exchange companies" we tries to investigate the relationship between disclosure level of financial reporting of TSE accepted companies with common profitability ratios, such as return on assets, return on equity, return on sales and dividend payout ratios. This paper is organized as follows: After reviewing of the literature study and describing and explaining of the assumptions, research methodology will be discussed. Then, the results of statistical analysis, discussion and conclusions will be presented in detail.

2. Literature Review

The increasing need of investors for using financial reports have been caused a lot of research to be done on the disclosure and reporting quality from the 1960s. The following will be mentioned both external and internal researches conducted. Nevertheless, these researches are on two aspects: first, Theoretical researches have been done by experts of disclosure principle without experimental evidences and second, the practical researches have been done by researchers based on data and experimental evidences of companies.

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Wang et al (2010) investigated the relationship between accounting information disclosure with the stock price of accepted companies in Taiwan Stock Exchange. The results show that companies with high levels of accounting information disclosure have a strong relationship between accounting earnings and stock market price than firms with low levels of accounting Information disclosure. They also found in this study, there is a strong positive relationship between book value and market price of shares of the companies with high level of disclosure. Amir and Kama (2005) showed that return on equity, net profit margin and total assets flow ratios effect on stocks returns by use of regression analysis. Lobo et al (2005) examined the relationship between disclosure quality and earnings management, they found that there is a strong negative relationship between disclosure quality and earnings management and companies that do not have adequate disclosure, they tend to manipulation of earnings and earnings components more than others. Len and Makhyja (1997) also studied the relationship between performance assessment criteria and stock return. The result showed that the ratios of economic value added, market value added, return on equity, return on assets and return on sales which are performance assessment criteria, had a significant relationship with stock return. Wallace et al (1994) conducted an empirical research on "the relationship between the comprehensiveness of companies' annual reports with the features of these companies in Spain". Return on equity and return on sales ratios were assumed as variables of financial features and found that companies with a higher return on equity and return on sales, tend to disclose less and vice versa. And the companies are accepted on the stock exchanges of Madrid and Valencia tends to disclose information with more comprehensiveness than companies are not accepted. Lang and Lundholm (1993) found out that companies which are larger and have a good performance, the level of information disclosure is higher. Cook (1992) did a study about "The Effects of firm size on the disclosure of industry type in the annual reports of Japanese companies ". He concluded that firm size (total assets) has a great relationship with the level of disclosure and disclosures in manufacturing companies are more than nonmanufacturing companies and those companies which are accepted on the stock exchange disclose more than other manufacturing companies. Singhvi & Desai (1971) did a study about "empirical analysis on the financial disclosure quality in the United States companies". Results showed that large companies compared to small companies, companies that have a greater number of shareholders, companies audited by major professional organizations (CPA) compared to audited companies by small professional organizations and companies with higher return on equity have a better quality of disclosure. Alan Robert Cerf has done a research on "reporting of companies and investment decisions" in the USA in 1961. He realized that the quality of financial reporting disclosure influenced on some variables and there is often no dependency between these variables. He determined 31 indicators of information disclosure in annual reports which later used by other researchers. In fact, he is the pioneer of empirical research in this field. The literature review of the disclosure and financial ratios shows in Iran also of researchers have considered the importance of information disclosure and analyzing financial ratios in different aspects up to now and they have examined its impacts on various cases. Sehat and Shariatpanahi (2013) did a research about the relationship between return on assets, return on equity and economic value added in insurance industry. The findings indicate that, there is a relatively strong and positive relationship between return on assets and return on equity with the margin of economic value added. Of course, the relationship with return on equity is higher. Mashayekhi and Mohammadabadi (2013) found that conservatism has a direct impact on the quality of disclosure and financial reporting. Shurvarzi and Nikomaram (1389) studied the effects of fluctuations in dividend payout ratio on the return on equity for 86 Tehran Stock Exchange companies during a period of 2001-13872007. The results show that there's a significant relationship between fluctuations of dividend payout ratio and stock returns. Reyhani (2014) examined the relationship between activity ratios and the level of information disclosure in financial statements of accepted companies in TSE. Generally results show there is a significant relationship between the level of disclosure in the financial statements with common activity ratios such as the ratio of sales to working capital, the ratio of sales to fixed assets, the ratio of sales to total asset and ratio of sales to equity (special value). Salehinejad (2013) investigated the effects of return on assets and return on equity and financial leverage on stock prices of 97 TSE companies for the period of 1999 to 2004. Results show that return on total assets and return on equity effect on the stock price, but financial leverage had no significant affect. Seyed Abadi (2004) did a research about the effects of firm size and financial ratios on full disclosure in the financial statements of accepted companies in TSE. He set a checklist of 168 cases of disclosure by considering Iranian accounting standards. The results show that there is a significant relationship between firm size and financial ratios like debt-to-equity ratio and the ratio of profit before tax to net sales with full disclosure. Mehrani and Mehrani (2003) examined the relationship between profitability ratios and stock return. Based on their findings, return on assets, return on equity, profit margin and profit margin before taxes ratios had a significant relationship with stock return. Also the results showed that return on assets ratio is more effective than other variables in predicting stock return. Malekiyan (1998) researched in the field of "comprehensiveness of annual reports and financial features of TSE companies". His results have shown that there is a significant relationship between firm sizes (total assets), debt-to-equity ratio, the amount of net sales and profit before tax to net sales ratio with full disclosure of annual reports; and there is no significant relationship between profits before tax to equity ratio with full disclosure of annual reports. In order to determine the significance of the relationship between profitability ratios with adequate disclosure of financial statements some hypotheses will be developed as follows:

The main hypothesis: there is a significant relationship between profitability ratios and adequate disclosure in the financial statements.

Subsidiary hypothesis (1): there is a significant relationship between the net profit to total assets ratio (ROA) and adequate disclosure in the financial statements.

Subsidiary hypothesis (2): there is a significant relationship between the net profit on equity ratio (ROE) and adequate disclosure in the financial statements.

Subsidiary hypothesis (3): there is a significant relationship between the net profit to net sales ratio (ROS) and adequate disclosure in the financial statements.

Subsidiary hypothesis (4): there is a significant relationship between the dividends to net profit ratio (DPR) and adequate disclosure in the financial statements.

3. Research method

The statistical population of this research is accepted companies in Tehran Stock Exchange and the sampling method is elimination method. In this method the companies which had the following requirements, were considered in the statistical sample and those companies those had not these conditions have been removed from the statistical sample. These conditions are as follows:

1. The study period is between 2008 to 2012.
2. In order to enhance comparability, the fiscal year of companies should be ended at the end of financial year.
3. The companies should be chosen among the accepted companies in Tehran Stock Exchange.
4. The selected Companies shouldn't be in industries such as banks, credit institutions, other financial intermediation, financial investments and multidisciplinary industrial companies.

According to the above information, the data collection was limited to a sample of 101 companies.

This research is a kind of applied and descriptive researches and historical information of companies and statistical methods will be used to confirm or refuse the hypothesis. In addition, library studies will be investigated on the theoretical basis and concepts. In this study, both descriptive and inferential methods will be used to analyze the collected data. In the descriptive level, with the use of statistical parameters such as abundance, average, standard deviation, maximum and minimum describes the general characteristics of society and in the inferential level, in order to respond to the hypotheses of research and also to find specific relationships among the components of society; regression analysis and Logit econometric model tests will be used. Since in this study, we assigned number 1 for companies with a rating equal to or higher than average ratings of companies and the Otherwise 0; two values of one and zero is used for disclosure variable. Therefore, based on econometric estimation, the method will be used should considers these two values of the dependent variable. Logit and Probit models have these features. So on the one hand according to the result for maximum likelihood function values, and on the other hand less degree of freedom in the Logit model than the probit model, Logit was chosen as more efficient model. The final analysis was performed using software Eviews 8 and Excel.

4. Research model

To test the hypotheses of the research, multivariate regression model were used as follows:

$$AD_{it} = \beta_0 + \beta_1 ROA_{it} + \beta_2 ROE_{it} + \beta_3 ROS_{it} + \beta_4 DPR_{it} + \varepsilon_{it} \quad (۱)$$

These variables are defined as follows:

Table 1. Operational definition of variables

Variable name	Operational definition
AD	According to the list of ranked companies in terms of adequacy of the disclosure published by the Tehran Stock Exchange, for companies with a rating equal to or higher than average disclosure ratings of companies assigned number 1 and otherwise 0.
ROA_{it}	The total returns on assets of the company i in year t. This is equal to the profit after tax divided by total assets.
ROE_{it}	Return on equity of the company i in year t. This is equal to the profit after tax divided by total equity.
ROS_{it}	Net profit margin ratio (return on sales) of the company i in year t. This is equal to the profit after tax divided by net sales.
DPR_{it}	The dividend payout ratio of the company i in year t. This is equal to the dividend payable divided by net profit.

5. Findings

5.1 descriptive statistics

Table (2) shows the descriptive analysis of the main accounting variables used in this study. Brief information on each one of the explanatory variables is in the following table:

Table 2. Analysis of descriptive statistics

Variable name	Mean	Median	Standard deviation	Maximum	Minimum
Return on total assets	0.13	0.11	0.13	0.62	-0.31
Return on equity	0.26	0.33	3.00	28.29	-72.69
Return on sales	0.18	0.15	0.33	6.85	-1.23
Dividend payout ratio	2.54	0.11	26.50	489.20	-27.14
Level of disclosure	0.55	1.00	0.49	1.00	0.00

5.2 Inferential statistics

The main hypothesis test: There is a significant relationship between profitability ratios and the level of adequate disclosure in the financial statements.

In order to test this hypothesis, it is needed to test hypotheses (1), (2), (3) and (4).

H1: First Subsidiary hypothesis: There is a significant relationship between the return on assets ratio and the level of adequate disclosure.

$$AD_{it} = \beta_0 + \beta_1 ROA_{it} + \varepsilon_{it} \quad (۲)$$

Table 3. The results of Logit model for the level of information disclosure with fixed effects.

Variables	Coefficients	Standard deviation	Z statistics	probability level	Ultimate effect
Return on total assets	5.2484	0.6819	7.6964	0.0000	2.01774
Constant coefficient	-0.4314	0.1142	-3.7767	0.0002	-0.1658
Diagnostic tests and adequacy of model					
McFadden determination coefficient			0.5741		
Likelihood log (probability level)			71.9769 (0.0000)		
The maximum likelihood function			-449.183		

According to the results of table (3), at 95 percent confidence level, the probability level of return on total assets obtained 0/0000, that this amount is less than 0.05, therefore, the null hypothesis is rejected and the alternative hypothesis is accepted, So there is a significant relationship between the return on assets ratio and the level of adequate disclosure in the financial statements. In estimating the model with the Logit method, by increasing each unit in return on total assets causes 5/ 2484 unit increasing in the level of information disclosure. Thus the first hypothesis of research that indicates a significant relationship between return on total assets with adequate disclosure, is accepted. The ultimate effect of this variable on the level of information disclosure is 2/01774 units, so the ultimate effect declined due to the value of coefficient of this variable.

H2: The second subsidiary hypothesis: There is a significant relationship between the return on equity ratio and the level of adequate disclosure.

$$AD_{it} = \beta_0 + \beta_1 ROE_{it} + \varepsilon_{it} \quad (۳)$$

Table 4. The results of Logit model for the level of information disclosure with fixed effects.

Variables	Coefficients	Standard deviation	Z statistics	probability level	Ultimate effect
Return on equity	0.0391	0.0433	0.9026	0.3667	0.0151
Constant coefficient	0.2246	0.0771	2.9131	0.0036	0.0871
Diagnostic tests and adequacy of model					
McFadden determination coefficient			0.4014		
Likelihood log (probability level)			11.447 (0.0089)		
The maximum likelihood function			-484.4481		

The statistical results showed that increasing each unit in the rate of return on equity cause 0.0391 unit insignificant increasing in the level of information disclosure. But according to the obtained probability level (0.3667) that is more than 0.05, the null hypothesis is accepted and the alternative hypothesis is rejected, so this relationship is not significant. Thus the second hypothesis that indicates a significant relationship between return on equity and adequate disclosure is rejected.

H3: The third subsidiary hypothesis: There is a significant relationship between return on sales ratio and the level of adequate disclosure.

$$AD_{it} = \beta_0 + \beta_1 ROS_{it} + \varepsilon_{it} \qquad (٤)$$

The results indicate that at the level of 95% confidence, the probability level is equal to zero and that is less than 0.05, so the null hypothesis is rejected and the alternative hypothesis is accepted. Increasing a unit in the rate of return on sales cause a significant increase 3/6494 unit in the level of information disclosure. So the third hypothesis that indicates a significant relationship between return on sales and adequate disclosure is accepted.

H4: The fourth subsidiary hypothesis: There is a significant relationship between dividends payout ratio and the level of adequate disclosure.

$$AD_{it} = \beta_0 + \beta_1 DPR_{it} + \varepsilon_{it} \qquad (٥)$$

The results indicate that in the 95% confidence level, the probability level is 0.9836 and which is more than 0.05, so the null hypothesis is accepted and the alternative hypothesis is rejected. In addition, increasing one unit in the dividend payout ratio cause -5.8692 unit reduction in the level of information disclosure. However, due to the probability level of this variable, this relationship is not significant. So the fourth hypothesis of research that indicates a significant relationship between the dividend payout ratio and adequate disclosure is rejected.

It should be noted that in all the variables, the ultimate effect due to the estimated coefficients, had a decreasing trend. In other words, over the selected time period, coefficients were not constant and have declined.

H5: Main hypothesis: There is a significant relationship between the profitability ratios and the level of adequate disclosure.

$$AD_{it} = \beta_0 + \beta_1 ROA_{it} + \beta_2 ROE_{it} + \beta_3 ROS_{it} + \beta_4 DPR_{it} + \varepsilon_{it} \qquad (٦)$$

Based on the results of the main hypothesis of research, according to Logit method at 95 percent confidence level, the probability level of return on total assets is 0/086 which this value is more than 0.05. While in the first subsidiary hypothesis this relationship was significant and the probability level was less than 0.05. The paradox created between the first sub-hypothesis and the main hypothesis in having a significant relationship with return on total assets is because of the presence of four profitability indexes in a model. When variables in a model are congener and similar to each other, the possibility of co-linearity increases between variables. Although profitability indexes have different values but they all reflect a company's profitability. Presence of return on total assets in the main hypothesis, on one hand it caused the co-linearity between variables and not being significant itself and on the other hand is a kind of absorber and controller of deviations of other variables in the model. Therefore, perhaps by removing this variable co-linearity between variables would be eliminated but it can cause deviations between dependent and independent variables. Thus according to the results of the first subsidiary hypothesis, the first hypothesis is significant, and there is a significant relationship between the return on total assets and adequate disclosure and first hypothesis is accepted.

Table 5. The results of Logit model for the level of information disclosure with fixed effects.

Variables	Coefficients	Standard deviation	Z statistics	probability level	Ultimate effect
Return on sales	3.6494	0.4737	7.7033	0.0000	1.3999
Constant coefficient	-0.4011	0.1134	-3.5349	0.0004	-0.1538
Diagnostic tests and adequacy of model					
McFadden determination coefficient			0.4809		
Likelihood log (probability level)			78.5509 (0.0000)		
The maximum likelihood function			-445.8963		

Table 6: The results of Logit model for the level of information disclosure with fixed effects.

Variables	Coefficients	Standard deviation	Z statistics	probability level	Ultimate effect
Dividend payout ratio	-5.8692	0.0028	-0.0205	0.9836	-2.2705
Constant coefficient	0.2360	0.0760	3.1020	0.0019	0.0915
Diagnostic tests and adequacy of model					
McFadden determination coefficient			0.6578		
Likelihood log (probability level)			70.3894 (0.00005)		
The maximum likelihood function			-485.1716		

Table 7. The results of Logit model for the level of information disclosure with fixed effects.

Variables	Coefficients	Standard deviation	Z statistics	probability level	Ultimate effect
Return on total assets	2.178	1.270	1.712	0.086	0.835
Return on equity	0.003	0.038	0.096	0.922	0.001
Return on sales	2.364	0.865	2.733	0.006	0.908
Dividend payout ratio	0.001	0.002	0.473	0.635	0.0005
Constant coefficient	-0.461	0.118	-3.898	0.0001	-0.177
Diagnostic tests and adequacy of model					
McFadden determination coefficient			0.184		
Likelihood log (probability level)			81.711 (0.000)		
The maximum likelihood function			-444.315		

For the second hypothesis, increasing each unit in the amount of return on equity cause 0/003 unit insignificant increase in the level of information disclosure.

But according to obtained probability level (0/922), which is more than 0.05, the null hypothesis is accepted and the alternative hypothesis is rejected, so this relationship is not significant. So the second hypothesis is rejected and there isn't a significant relationship between return on equity and adequate disclosure. Test results of the third hypothesis indicate that in the 95% confidence level, the probability level is 0/006 which is less than 0.05 and consequently the null hypothesis is rejected and the alternative hypothesis is accepted. In addition, each unit increase in the return on sales cause a 2/36 unit significant increase in the level of information disclosure. So the third hypothesis of research that indicates a significant relationship between return on sales and adequate disclosure is accepted. In the fourth hypothesis, the probability level is 0/635 in the 95% confidence level, which is more than 0.05 and consequently the null hypothesis is accepted and the alternative hypothesis is rejected. In addition, each unit increases in the dividend payout ratio cause a 0/001 unit insignificant increase in the level of information disclosure. However, due to the probability level of this variable, this relationship is not significant. So the fourth hypothesis of research that indicates a significant relationship between the dividend payout ratio and adequate disclosure is rejected. It should be noted that in all the variables, the ultimate effect due to the estimated coefficients, had a decreasing trend. In other words, over the selected time period, coefficients were not constant and have declined. McFadden determination coefficient shows the explanatory power of the independent variables. In other words, in this model, about 18 percent of the explanatory variables could explain the dependent variable. This coefficient in data panel is not dependent to higher values, when it has the positive value, shows suitability of the model. McFadden determination coefficient and likelihood ratio indicate the suitability and significance of all coefficients in the regression of this model.

6. Discussion and conclusion

This study seeks to clarify the fact that is there any significant relationship between disclosure levels of the financial statements in Tehran Stock Exchange companies with common profitability ratios? Or in other words, whether there is a significant relationship between the level of disclosure in financial reporting of accepted companies in Tehran Stock Exchange with common profitability ratios such as Return on Asset, Return on Equity, and Return on Sales and Dividend Payout Ratio? So this study assesses and measures the adequacy of the disclosure and the common profitability ratios in the financial statements of 101 companies for the period 2009 to 20014. In order to analyze the data, we use Cook's model framework (1992) in Japan, and frameworks of other researchers like Malekiyan (1998) and Arziton (2005) in Iran. In accordance to previous parts, the original model of research is multiple variable regressions and to estimate the models, the Logit econometric methods used in this study. Therefore, among the research hypothesis, the second and fourth hypotheses are rejected and the first and third hypotheses are accepted:

(H1): there is a significant relationship between the ratio of net profit to total assets (ROA) and adequate disclosure in the financial statements.

(H2): there is not a significant relationship between the ratio of net profit on equity (ROE) and adequate disclosure in the financial statements.

(H3): there is a significant relationship between the ratio of net profit to net sales (ROS) and adequate disclosure in the financial statements.

(H4): there is not a significant relationship between the ratio of dividends to net profit (DPR) and adequate disclosure in the financial statements.

It means there is no significant relationship between the level of disclosure with return on equity and dividend payout ratios, but there is a significant relationship between the level of disclosure with return on assets and return on sales ratios.

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