Corporate Governance Factors Influence to the Voluntary Disclosures in Banking and Finance Companies in Sri Lanka

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Abstract

The purpose of this research is to examine the relationship between corporate governance variables and voluntary disclosure level in banking and finance companies which are registered in the Colombo Stock Exchange (CSE) in Sri Lanka. To measure voluntary disclosure level of aforesaid companies used content analysis of annual reports for the period between 2012 and 2015. This study has developed a voluntary disclosure index which includes 83 items under 9 sub categories with the intention of measuring level of voluntary disclosures. Panel data analysis used to measure the relationships and this study used size of the board, proportion of independent directors, and board with female directors, a large audit firm as independent variables. Size of the firm, profitability, age and leverage are used as control variables. Empirical results of study indicates that independent directors and female directors on the board have significant positive relationships with voluntary disclosures whereas the board size has an insignificant positive relationship with voluntary disclosures and there is a significant negative relationship between voluntary disclosures and corporate governance.

Keywords: *Banking and Finance Company, Corporate governance, CSE, Panel data analysis, Voluntary disclosures*

Introduction

Corporate disclosures are a growing importance phenomena in capital markets of both developed and developing countries. Corporate disclosures can be categorized by ways of mandatory disclosures and voluntary disclosures. Voluntary disclosures are free reveals. Disclosures which reveal consistent with regulatory and legal requirements are considered mandatory disclosures (Cooke, 1992).

According to the International Financial Reporting Standards (IFRSs), the key purpose of the financial report is to provide essential information to investors, lenders, creditors and other uses of facts reported in the financial statements. Therefore, companies communicate their information to stakeholders of company via financial report to take decisions (Bagnoli & Watts, 2007). Managers use voluntary disclosures as a tool of filling information gaps between managers and other stakeholders. Due to the importance of voluntary disclosures provided in annual reports, this area is very attractive among scholars, in past few decades.

Even though the aim of the corporation is to maximize the shareholder value, there is a possibility for agency conflicts (Fama and Jensen, 1983). Managers can diminish the degree of disclosure level to hide the real performance from principals (owners) of the company. In order to solve this information asymmetry the governing board should play an important role. Strong governance mechanism willing to increase management encouragements to disclosure more information to stake holders of corporations in order to diminish the information asymmetry (Charumathi and Ramesh, 2015). Based on that research question is recognize the connection between corporate governance determinants and voluntary disclosure level.

The key objective of this research is to measure the relationship between corporate governance variables and voluntary disclosure level in banking and finance companies listed in the Colombo Stock Exchange (CSE) in Sri Lanka. Sri Lanka is a middle income earning developing country (World Bank, 2015) and corporate governance was introduced to the Sri Lanka in 1977 and has updated in 2003, 2008 and 2013 with the purpose of direct and control the corporations (The Institute of Chartered Accountants of Sri Lank and Securities and Exchange Commission of Sri Lanka, 2013).

The study contributes to existing literature in several ways. At present, there is a deficiency of research which examine the relationship between the governance structure and voluntary disclosure levels in Sri Lankan companies. This study empirically tests the relationship between corporate governance and voluntary disclosure levels based on 50 listed companies which are registered in the CSE under Banking industry and Finance industry for the years of 2012 to 2015. This study contributes to the theoretical domain as well as practical domain. Based on results of this study management of organizations and governing bodies can identify the determinations of voluntary disclosures which will support decision marking processes, and these results will also be significant to both current and future investors.

The paper is organized as follows: Literature related to this study is presented in section two. In third section describes data and methodology, Section number four covers the results and discussion. The conclusion limitations and future research are presented in section five.

Literature Review and Hypothesis Development

Agency Theory which was initially developed by Ross, 1973 and it was more extended by Jensen and Meckling, 1976. Agency Theory explain the owner (principal) – manager (agent) relationship. Owners assign managers to execute services, granting decision making power in the best interests of owners. Separation of owner manager relationship cause to generate agency cost (Eisenhardt, 1989). With the intention of reducing agency problems and agency cost, owners appoint a director board to observe the effort of management (Jensen and Meckling, 1976; Aguilera and Jackson, 2003). To mitigate the agency cost which arises through the asymmetry of information between owners and management, managers improve levels of disclosures (Gul & Leung, 2004).

Voluntary disclosures are a border debated and well researched area in both developed and developing countries' contexts since the study done by Cerf, 1961. This topic is very attractive among academics. Studies done by several scholars such as; Naser, Alkhatib, and Karbhari, 2002; Barako, Hancock, and Izan, 2006; Iatridis and Alexakis, 2012; Charumathi and Ramesh, 2015 are general examples. Moreover the association between determinants of corporate governance and voluntary disclosures have been empirically tested using Agency Theory in various researches such as; Eng and Mak, 2003; Gul and Leung, 2004; Shamil, Shaikh, Ho, and rishnan, 2014.

Taking Agency Theory as the theoretical foundation for the study, following hypothesis were established;

Board Size

Two conflicting views have been suggested in prior literature about board size. They are larger boards and smaller boards. Some scholars support smaller boards while others support larger boards. Certain past research state that even though larger boards are unlikely to be controlled by agent (management), smaller boards are more likely to be controlled by management (Hermalin and Weisbach, 2003). Larger boards are inefficient due to feebler influence from management and this causes an increase in agency conflicts and agency cost (Lim, Matolcsy, and Chow, 2007).

Furthermore, previous research has found a positive relationship between size of the board and voluntary disclosures (Lim, Matolcsy, and Chow, 2007; Laksmana, 2008). Likewise, some other prior researches have discovered positive associations between corporate social responsibility (CSR) disclosures and board size (Esa, Anum, and Gazali; Ntim and Soobaroyen, 2013). Furthermore, according to Shamil, Shaikh, Ho, and Krishnan, 2014 board size positively associates with sustainability reporting. Based on aforesaid empirical findings, study hypothesized that:

H1. There is a positive relationship between board size and voluntary disclosures.

Board Independence

According to Jensen and Meckling, 1976; Fama and Jensen, 1983; Barako, Hancock, and Izan, 2006, Agency Theory suggests that when increasing the board independent directors, agency conflicts and agency cost will reduced. Therefore in order to diminish agency conflicts, boards which have large percentage independent directors can force the management to disclose information.

Chau and Gray, 2010 argued that there is a positive relationship between proportion of independent directors on the board and voluntary disclosures. Contrary to this argument some scholars state the negative relationship between proportion of independent directors on the board and voluntary disclosures (Eng and Mak, 2003 ; Barako, Hancock, and Izan, 2006). However, the findings of empirical studies Ho and Wong, 2001; Boesso and Kumar, 2007 stated that there is not any relationship between proportion of independent directors on the board and voluntary disclosures. Based on prior studies, study test the below hypothesis:

H2. There is a positive relationship between board independence and voluntary disclosures

Board with Female Directors

A Board with female directors is a vital phase in corporate governance literature. Findings of empirical analysis on the relationship between female directors on board and voluntary disclosures are mixed. Studies such as (Barako and Brown, 2008; Bear, Rahman, and Post, 2010) found positive association between board with female directors and Corporate Social Responsibility (CSR) disclosures. However, Ntim and Soobaroyen, 2013 identified that there is no any association between board with female directors and CSR disclosures. A recent study which was done by Shamil, Shaikh, Ho, and Krishnan, 2014 on corporate governance and sustainability reporting, found the negative relationship between board with female directors and sustainability disclosures. Aligned with these empirical findings study construct the following hypothesis is put to test:

H3. There is a positive relationship between board with female directors and voluntary disclosures

Audit Firm Size

Maintaining reputation is very essential for larger audit firms, therefore bigger audit firms motivate their clients to execute standards for disclosing more widespread important information. Apart from that, big audit firms try to continue their independent status continuously. Hence managers who are willing to get benefits from outside monitoring also try to find the services from big audit firms. Consequently, managers agree to disclose quality information with compliance to the requirements of large audit firms. That is, simply employing a large audit firm indicates a managers enthusiasm on disclosing high quality information (Xiao, Yang, and Chow, 2004; Albawwat, 2015)

Prior studies on larger and smaller audit firms have created different results. According to the Craswell and Taylor, 1992; Inchausti, 1997; Lopes and Rodrigues, 2007; Wang, Sewon, and Claiborne, 2008 there is a positive relationship between a larger audit firm and the extent of disclosures. Also, there are some firms which hires larger audit firms but do not disclosure more information (Owusu-Ansah, 1998). In consequence, consistent with the above-mentioned evidences, study hypothesized that:

H4. There is a positive relationship between larger audit firms and voluntary disclosures

2.1.Control Variables

This empirical model includes key firm-specific characteristics as control variables. They are, firm size that measures through logarithm of total assets, firm profitability which calculated net profit dividing by total asset, listing age of the firm and leverage ratio though debt to equity.

Methodology

This section defines the tools used to accomplish objective of the research. First explains the population of the study then sample and finally data and methodology of the study.

The sample of 50 companies used to study out of all companies which are registered in CSE under banking and finance and insurance sector. 62 companies have registered under aforesaid sector in CSE. Insurance companies registered in CSE and companies with inadequate information were excluded from the sample. Ultimately 50 companies were used as the final sample and data collected over a period of 4 years (2012 to 2015). Therefore, the study consists of 200 observations.

This study analyzed present or absents of items in disclosure index. Disclosure index is presenting in Table I. A firm that presents disclosures was allocated “1” and allocated “0” for absents disclosures. Then to calculate total of the companies, score of every items added to compute company each year total and to calculate level of voluntary disclosures, it matched with all the other voluntary disclosures according to study done by Leventis & Weetman, 2004. Hence calculated index of voluntary disclosures as follows; Voluntary disclosure index = Total of items which are disclosure voluntary /all considered voluntary disclosures (83).

Table 1: Voluntary Disclosure Index

A. **Background about the Bank, Finance company or Insurance company/ General Information (11)**	E.10 Disclosures on value-at-risk (VAR)
A.1. Brief narrative history of the bank/ Finance company	E.11. Maturity of foreign currency assets and liabilities
A.2. Description of bank/ Finance company Structure	E.12. Maturity information about deposits and other liabilities
A.3. Description of major services	
A.4. The legal form of the bank/ Finance company	**F. Forward looking information (9)**
A.5. Address of bank or Finance company/telephone/fax	F.1. Forecasts of cash flows
A.6. Bank / Finance company Website address	F.2. Forecasts of revenue
A.7. Email address	F.3. Economic influence to bank’s or company’s future
A.8. Date and details of establishment	F.4. Political influence to bank’s or company’s future
A.9. General Outlook of business activities	F.5. legal influence to bank’s or company’s future
A.10. List of branches location	F.6. Social influence to bank’s or company’s future
A.11. Information on branches/telephone/fax/ adders for correspondence	F.7. Technological influence to bank’s or company’s future

	F.8. Impact on strategies to the future performance
B. Corporate Strategy (6)	F.9. Discussion on future industry trend
B.2. Corporate Mission	G. **Human and Intellectual Capital (16)**
B.3. Corporate Goals and Objectives	G.1. Marketing innovation
B.4. Corporate ethics	G.2. Brand values
B.5. Corporate Values	G.3.Value of customer relationship
B.6. Corporate Strategies	G.4.Value of patent/trademarks
	G.5. Rand D facilities
C. Corporate Environment (5)	G.6.No. Of employees engaged in Rand D
C.1. General Outlook of the economic environment	G.7. Rand D focus areas
C.2. General Outlook of the industry environment	G.8.Total No. of employees
C.3. General Outlook of the social environment	G.9. Category of employees by gender
C.4. General Outlook of the legal environment	G.10. Policy on training
C.5. General Outlook about the political environment	G.11. Category of employees undergoing training
	G.12. Amount spent on employee training
D. Financial Performance (10)	G.13. Equal opportunity policy statement
D.1 Brief discussion and analysis of a bank's / Finance company's financial position.	G.14. Employee safety policies
D.2. Qualitative forecast of earnings	G.15. Employee recruitment policy
D.3. Return on equity	G.16.Human resources accounting
D.4. Net interest margin	
D.5. Earnings per share	**H. Competitive Environment and Outlook (6)**
D.6. Risk weighted assets	H.1. Estimation of market size

D.7. Debt to Equity ratio	H.2. Estimation of market growth
D.8. Total liquid asset to assets ratio	H.3. Market share analysis
D.9. Loan to deposit ratio	H.4.Barriers to entry
D.10 Dividend per share	H.5.Competitive environment
	H.6. Impact of competition on profit
E. Risk Management (12)	
E.1. Information on risk management committee	**I. Corporate social responsibility (8)**
E.2. Information on assets liability management committee	I.1. Sponsoring public health, sporting or recreational projects
E.3. Information on risk management structure	I.2. Information on donations to charitable organizations
E.4. Information on credit management structure	I.3. Supporting national pride/ government.- sponsored campaigns
E.5. Quantitative information on gross loan/deposits	I.4. Environmental protection program implemented
E.6. Amount and details of problem loans or details by internal risk ratings	I.5. Awards for environmental protection
E.7. Disclosure of credit rating system	I.6. Employee's appreciation
E.8. Ageing schedule of past due loans and advances	I.7. Discussion of employees' welfare
E.9. General descriptions of market risk segments	I.8. Statement of corporate social responsibility

This voluntary disclosure index was developed based on the studies of Bhasin, Makarav, and Orazalin, 2012; Ismail and El-Shaib, 2012; Al-Shammari, 2013; Haji and Ghazail, 2013; Ho and Taylor, 2013; Charumathi and Ramesh, 2015; Abeywardana and Panditharathna, 2016. Hence these disclosures items were equally important for the study used unweight method to score the stuffs in disclosure index (Cooke, 1989; Hossain, Tan, and Adams, 1994; Wallace, Naser, and Mora, 1994; Naser, Alkhatib, and Karbhari, 2002; Ousama and Fatima, 2010).

Operationalization of the independent variables (board size, board independence, boards with female directors, larger audit firm) and control variables (firm size, profitability, age and leverage) of the study have been developed based on prior literature and that is present in Table II.

Table 2: Operationalization

Variable	**Measurement**	**Prior Studies support to the measurement of the study**
Independent		
Board size (bs)	Total number of directors on the board	Laksmana, 2008; Lim, Matolcsy, and Chow, 2007; Shamil, Shaikh, Ho, and Krishnan, 2014)
Proportion of independence directors (pid)	Number of non-executive independent directors on the board as a percentage of the total number of directors of the company.	Eng and Mak, 2003; Barako and Brown, 2008; Ho and Wong, 2001; Haniffa and Cooke, 2002
Board with female directors (fd)	If company has female directors placed (1) and (0) if otherwise	Shamil, Shaikh, Ho, and Krishnan, 2014; Ntim and Soobaroyen, 2013
Larger audit firm (laf)	If company has audited from big 4 audit firms placed (1) and (0) if otherwise	Craswell and Taylor, 1992; Inchausti, 1997
Control		
Size	Logarithm of total assets	Barako, Hancock, and Izan, 2006; White, Lee, and Tower, 2007
Profitability (prof)	Net Profit/ Total Assets	Meek, Roberts, and Gray, 1995; Charumathi and Ramesh, 2015
Age	Listing Age	Owusu-Ansah, 1998; Haniffa and Cooke, 2002
Leverage (lev)	Debt/ Equity	Leventis and Weetman, 2004; Charumathi and Ramesh, 2015

This study used panel data analysis methodology. Panel include 200 observations over the period of 2012 to 2015. To proceed with analysis study used following regression model.

$$VD_{it} = \propto_{it} + \beta X_{it} + \eta_i + \nu_t + \varepsilon_{it}$$

Where,

VD_{it} = Level of Voluntary Disclosure of the I firm and t time

X_{it} = Corporate Governance variables which contain board size (bs), board independence (bi), board with female directors (bfd), larger audit firm (laf) and Firm specific characteristics which consisits firm size, profitability (prof), age and leverage (lev)

η_i = Firm specific effect which unobservable

ν_t = Fixed effect year

Panel data analysis techniques were used for the study to identify the relationship between corporate governance determinants of voluntary disclosures. As a first step through F test inspects the group attempts to check which model is more appropriate from pooled Ordinary Least Square (OLS) and Fixed Effect (FE) model. This test was conducted to see whether there is the fixed effect or not (Park, 2011)

In the second step carried out, the Hausman test was used in order to understand which model is better from FE model and random effect model. The Hausman test compares the fixed and random effect models under the null hypothesis where unobservable effect is uncorrelated with any repressors' of the model (Hausman, 1978)

Thirdly, it tests the existence of time fixed effect. Also the study tested the multi-collinearity by employing Variance Inflation Factor (VIF) and tolerance value. Furthermore, cross sectional dependence,

heteroskedasticity and serial correlation by employing pesaran's test of cross sectional dependence, modified Wald test and Wooldridge test respectively for panel data to assure that the study used well behaved panel data and the null hypothesis of these tests are no cross sectional dependence, no heteroskedasticity and no serial correlation respectively.
Based on that study developed the following model;

Analysis of Results

This section presents analysis of data, results and findings.

F test and Hausman test carried out to identify the best model which should be used to identify the corporate governance determinants of voluntary disclosures. P value of F test is 0.0000 which leads to reject the null hypothesis i.e. there is no firm fixed effect. This result indicated that the fixed effect model was better than the pooled OLS model. Further, p value of Hausman test is 0.0000 and therefore the null hypothesis of cross-section random effects is rejected. In this case, the fixed effect estimation is used to random effect model. Therefore, the results confirmed that the fixed effect model is an appropriate method to identify the determinants of voluntary disclosures.

Furthermore, to assure that the study used well behaved panel data firstly it tested that the multi-collinearity and VIF values lie below 10 and tolerance values are lie above 0.10 and it indicates that each independent variable act independently. Since the P values are 0.1287, 0.099 and 0.088 for the results of Pesaran's Test of Cross-sectional Dependence, Modified Wald Test for Group Wise Heteroskedasticity and Wooldridge Test for Autocorrelation respectively, the study assured that there is no cross sectional dependence, no heteroskedasticity and no serial correlation.

Based on the identification of the best model, table III presents the empirical results of the fixed effect model which was used to identify the determinant of voluntary disclosures.

Table 3: Results of Fixed Effect Model

Periods included: 4
Cross-sections included: 50
Total panel (balanced) observations: 200
Dependent Variable: Voluntary Disclosure Level

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Bs	.0030837	.002827	1.09	0.277
Bi	.0799847	.0336948	2.37	0.019**
Bfd	.0028165	.0119245	1.24	0.014**
Laf	-.0200816	.0150407	-1.74	0.084*
Size	.0467572	.0225687	2.07	0.040**
Prof	.1115931	.048763	2.29	0.024**
Age	.0198049	.0027447	7.22	0.000***
Lev	-.0020636	.0007445	-2.77	0.006***
C	-.6055757	.1893017	-3.20	0.002***

R-squared = 0.65
Adjusted R-squared = 0.6034
Significant levels = * * *1% level, * *5%levl and *10% level.

Independence directors on the board and board with female directors are positively associated with the level of companies' voluntary disclosure and provide huge support to the Hypothesis No 2 and 3. Even though larger audit firms are significant the relationship is negative and it does not support the expected positive relationship in 4th hypothesis. Even though the relationship between number of directors on the boards and level of voluntary disclosures expect a positive sign, board size variable absences statistical significance, therefore H1 have to reject. In addition to the independent variables, control variables; firm size, profitability and age have positive significant relationships with voluntary disclosure level. Furthermore leverage has a significant negative relationship with voluntary disclosures.

Discussion

The results show that the proportion of independent directors has a significant positive association with voluntary disclosures and it is complying with the study done by Chau and Gray, 2010 which suggests good observing by independent directors is the cause to increase level of voluntary disclosures. Similar to that board female directors have a significant positive relationship with voluntary disclosures and this is similar to the study done by Bear, Rahman, and Post, 2010 which implies that firms with female directors disclosed more information other than to the firms without female directors. Furthermore, large audit firms have a significant negative relationship with voluntary disclosures which implies that odds in voluntary disclosures in a firm with larger audit firm is 0.020 compared to the firms do not have a larger audit firm. This is similar to the study done by Owusu-Ansah, 1998. Even though there is a positive association between board size and level of voluntary disclosures it is lack with significant.

Conclusion

According to the Agency Theory perspectives, this study inspected the association between corporate governance variable and voluntary disclosures. A sample of 50 listed companies from the sectors of banking finance and insurance in CSE Sri Lanka was selected for this study.

Observed findings of this study is compliance with the Agency Theory, although it is not applicable for all corporate governance variables. The level of voluntary disclosures in the companies of banking and finance are subsist on some corporate governance factors such as board independence, board with female directors and larger audit firm. However, number of directors on the board have an insignificant relationship with level of voluntary disclosures. Based on the results of this study stakeholders can be informed about the disclosure practices in the banking and finance industry to create great decisions.

Findings of this study have several limitations. Depended variable of this study has been measured as binary variable therefore it does not measure quality of disclosures. Therefore future researchers should investigate the relationship between good corporate governance and quality of voluntary disclosures. Furthermore, the study tested the relationship between corporate governance determinants with voluntary disclosures in the companies which are registered in CSE under the banking and finance sector. Other than bank finance and insurance sector most companies have registered in CSE under 19 different sectors. Future researchers also can test the relationship using all companies which are registered in CSE as sample. Future studies need to examine the effect of board effectiveness, board committees, ownership structure and profile of directors on voluntary disclosure level.

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