Does Corporate Governance Contribute towards Financial Information Disclosure in Malaysian Listed Banks?

Abstract

Financial information disclosed in the annual report is one of the main sources that investors are interested to make informed judgment in their decision for investment. Due to the financial crisis, Malaysian Code on Corporate Governance was introduced and this Code mentions that one of the tasks of the directors is to provide timely and useful information disclosure. However, in Malaysia, there is not much study on the corporate governance in the banking sector even though this industry is the heart of the country economy. Thus, this study investigates whether corporate governance can contribute to have better financial information disclosure of Malaysian listed bank by using a panel data regression analysis. Corporate governance variables are the board leadership structure, board composition, board size, director ownership, institutional ownership and block ownership. Disclosure index is developed by researcher and conducts content analysis by cross checking between the information disclosure in the annual reports and the disclosure index. The opinion of accountants and financial analysts are used to compute weighted disclosure score because they are preparers and users of the accounting information. This research finds that separate board leadership structure, higher proportion of independent directors on the board, smaller board size, higher director ownership, higher institutional ownership and lower block ownership have higher financial information disclosure.

Key words: corporate governance, financial information disclosure, banks

1.0 Introduction

Corporate governance becomes an essential issue nowadays and it has been recognized as one of the main sources of corporate problems. Poor corporate governance is accused as one of the main causes of crisis. Many corporate governance theories and Corporate Governance Codes collectively agree that having good corporate governance system will strengthen the internal control procedures of the corporations and will enhance the disclosure information about the performance of the corporation (Apostolos and Konstantinos, 2009). In addition, among the different types of industries, corporate governance system of banks seems to be more important because the banking sector is the heart of any country economic situations (Matama, 2008). If a weak corporate governance exists, investors may lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a liquidity crisis and then it might lead to economic crisis in a country and pose a systemic risk to the society at large (Basel Committee on banking supervision, 2005; Garcia-Marco & Robles-Fernandez, 2008). Therefore, it is interested to examine the importance of corporate governance mechanisms in the banking sector.

Similarly, the importance of the financial information disclosure in the annual reports has been highlighted as one of the important aspects of the good corporate governance. According to Basel committee on banking supervision (2005), Xue (2008) and Tian and Chen (2009), information disclosure is important as it is the heart of corporate governance. They further state that good financial information disclosure is a signal for the better performance of the corporation, reducing the information asymmetry, clarifying the conflict of interests between the shareholders and the management, and making corporate management accountable. Among the different types of information disclosed in the annual reports, disclosure on financial information is focused in this study because disclosing financial information is necessary since investors mainly rely on the financial information disclosed in the annual report and more financial information will enhance transparency, reduce opportunistic behaviors and information asymmetry and management cannot hold the important information for their own benefits (Marleen, et.al., 2005; Apostolos and Konstantinos, 2009). However, most of the developing countries do not have strong policy on financial reporting (Ionescu, 2010). Therefore, this study fills up the gap by examining the impact of corporate governance on financial reporting in the financial sector.

It could be summed that the governance seems to be a heart of the corporation, especially in the banking sector and to have an influential power on information disclosure of the annual reports. Hence, the aim of this paper is to investigate the impact of corporate governance on the financial information disclosure of the banks. This research is presented in 5 sections. The second section discusses the relevant literature. The third section elaborates on development of hypotheses and research design. The fourth section explains findings and the last section concludes.

2.0 Literature Review

Jensen and Meckling (1976) mention in their paper that due to the separation of ownership and control, agency problems, i.e. moral hazard (hidden action) and adverse selection (hidden information) could occur and the directors might maximize their own interests at the expense of the shareholders. Thus, the main issue from the agency theory is the existence of agency cost (Williams et al., 2006). The suggested mechanism to minimize this cost is good corporate governance (Judge et al., 2003) since it promotes goal congruence among principals and agents (Conyon & Schwalbach, 2000). Cheung and Chan (2004) also describe that the ultimate goal of corporate governance is to monitor the management decision-making in order to ensure that it is in line with shareholders' interests, and to motivate managerial behavior towards enhancing the firms' wealth. It is also highlighted in this study is that information disclosure is one of the tool to reduce the cost of capital and to provide more transparent information to the shareholders. By doing that, agency conflicts will reduce since the shareholders are able to monitor the management based on the information disclosure. The following discussions provide some explanations of corporate governance mechanisms from the agency theory perspective and most relevant the empirical finds related to this research.

Regarding the issue of board leadership structure, agency theory and most of the corporate guidelines recommends for separate board leader structure in order to ensure that the performance of the CEO is independently monitored by the different person, i.e. board chairman (Jensen & Meckling, 1976; Florackis & Ozkan, 2004). The independence of the board attained by separate leadership is necessary so that the board will be able to give pressure on the management led by CEO in disclosing the more material information about the company, which is in line with the interest of the shareholders. Hence, it could be assumed that the separate leadership structure will lead to better financial information disclosure about the companies. The findings of Ho and Wong (2001), Gul and Leung (2004), Lakhal (2005), Byard, Li and Weintrop (2006) and Huafang and Jianguo (2007) are in line with theoretical expectation. This means that there is a positive relationship between separate leadership structure and disclosure. In the case of study by Norita and Shamsul Nahar (2004), the results show that separate leadership structure is not associated with disclosure.

According to Choe and Lee (2003), board composition is very important to effectively monitor the managers and reduce the agency cost. Although the executive directors have specialized skills, expertise and valuable knowledge of the firms' operating policies and day-to-day activities, there is a need for the independent directors to contribute the fresh ideas, independence, objectivity and expertise gained from their own fields (Weir, 2003). Hence, the agency theory recommends the involvement of independent non-executive directors to monitor any self-interested actions by managers and to minimize agency costs (Florackis & Ozkan, 2004; Williams et al. 2006). In addition, it can be derived from the agency theory that higher proportion of the independent non-executive directors on the board will be result in higher disclosure of the material aspects of the company in order to increase the transparency since independent boards will be able to encourage the management to disclose more information. The findings of Chen and Jaggi (2000), Gul and Leung (2004), Byard et al. (2006), and Cheng and Courtenay (2006) and Norita and Shamsul Nahar (2004.) are in line with theoretical expectation.

In order to have the effective number of board size, Jensen (1983) and Florackis and Ozkan (2004) suggest not having more than seven or eight members to avoid less effective coordination, communication, and decision making. Smaller board size seems to be more conducive to board member participation and thus would result in a positive impact on the monitoring function and the decision-making capability of the board, and independence from the management (Huther, 1997). It is expected that smaller board size should be able to monitor the decision of the management related to the information disclosure. This expectation is supported by the findings of Byard et al. (2006). They study 1279 firms over the years 2000 to 2002 and find that financial disclosure related to forecast information decreases with board size. However, the finding of Lakhal (2005) show that there is an insignificant and weak association between board size and disclosure.

Agency theory stresses the importance of ownership structure in enhancing corporate governance. It could be viewed from three different perspectives; (a) director ownership, (b) block ownership, and (c) institutional ownership. If directors own shares, the directors as the owners themselves are directly instructing and monitoring the management of the companies (Jensen & Meckling, 1976). Hence, there are likely to be fewer agency problems as compared to the situation where the directors, who are not the owners, supervise the management of the company. It is also supported by Seifert et al. (2005) who discuss agency conflicts. However, in the case of information disclosure, the effect of director ownership on disclosure might be different from that of the block holders and institutional investors. Directors who have substantial amount of share ownership might not want to disclose the information to the outsiders because they can use their discretionary powers to spend firm resources in ways that serve their own interest at the expense of other shareholders and then they might want to conceal fraud and incompetence, if any. Therefore, it could be expected that there is a negative relationship between director ownership and disclosure. Theoretical expectation seems to be supported by Chau and Gray (2002), Eng and Mak (2003), and Leung and Horwitz (2004).

With regard to block ownership, if an individual has a substantial amount of interest in a particular company (usually measured at 5%), he or she will be more interested in the company, compared to the shareholders who own a smaller number of shares because dispersed ownership may have less incentives to monitor management (Kim & Lee, 2003). Ownership by the block holders is an important player to have higher disclosure since they have the voting power that could be used as a tool to monitor the agents (David & Kochhar, 1996). Agency theory also suggests that block holders have the interests in the firms; most likely they might put the pressure on the management to disclose all the material information. This could be due to the significant proportion of shares held by block holders. Therefore, it could be expected that there is a positive relationship between block holders and disclosure. Chau and Gray (2002), Luo, Courtenay and Hossain (2006)[1], Huafang and Jianguo (2007) and Norita and Shamsul Nahar (2004) find that extent of outside block ownership is positively associated with disclosures and hence their finding is in line with theoretical expectation. However, Eng and Mak (2003) find that block holder ownership is not related to disclosure.

Lastly, regarding institutional investors, Salleh and Mallin (2002), Kim and Nofsinger (2004), Leng (2004), Soloman and Solomon (2004), Seifert et al. (2005), Le et al. (2006), Langnan, Steven and Weibin (2007) and Ramzi (2008) collectively agree on the important role of institutional shareholders in the monitoring of firms. Ownership by the institutional shareholders is large enough to motivate them to monitor, compared to a shareholder with small amount of ownership. Therefore, it could be expected that there is a positive relationship between institutional investors and disclosure. The findings of Eng and Mak (2003), and Lakhal (2005) are in line with theoretical expectation. However, Huafang and Jianguo (2007) find that there is state ownership and legal ownership is not related to disclosure.

3.0 Development of Hypotheses and Research Design

3.1 Development of Hypotheses

Disclosing the material information, especially financial information disclosure, of the firms reduces the information asymmetry between the management and the owners, and it will also reduce the agency conflicts between them (Apostolos & Konstantinos, 2009; Akhtaruddin & Hossain, 2008). Disclosure is an integral part of the corporate governance because it shows the extent of how good corporate governance is (Patel et al., 2002; United Nation, 2003). Leong (2005) also mentions that disclosure and transparency are partners of good corporate governance. Moreover, Beekes and Brown (2006) study 250 Australian firms rated in the 2002 Horwath Corporate Governance Report and find that better-governed firms do make more informative disclosure. Hence, the researcher is interested to examine whether corporate governance variables could affect the financial information disclosure and the following hypotheses are developed.

H_{a1}: Financial information disclosure is positively related to separate leadership structure.

H_{a2}: Financial information disclosure is positively related to proportion of independent non-executive directors on the board.

H_{a3}: Financial information disclosure is negatively related to board size.
H_{a4}: Financial information disclosure is negatively related to director ownership.
H_{a5}: Financial information disclosure is positively related to block ownership.
H_{a6}: Financial information disclosure is positively related to institutional ownership.

3.2 Research Design

Variables and Empirical Model

<u>Dependent Variable</u>

Weighted financial information disclosure score is used as a dependent variable; questionnaire is developed to obtain views on the importance of each disclosure item from financial analysts and accountants. Before the actual questionnaire is sent, pilot test has been conducted and the findings show that alpha value is 0.94 and so it has been concluded that the

questionnaire is reliable. In addition, pilot test results show that the overall mean score for comprehensiveness of the questionnaire is 4.05, for understandability of the questions are 4.10 and for understandability of the instruction is 4.62. Therefore, it can be concluded that the pilot test questionnaire is good enough to be used as an actual questionnaire.

The weighted financial information disclosure score used in this study is based on the opinions of one hundred and thirty one accountants and fifty one financial analysts. There is no non-response bias from the questionnaire received from the accountants and financial analysts based on T statistics and Mann-Whitney U test. The reliability test results show that the alpha value is 0.9 and so the weighted financial accounting disclosure score used in this study is reliable. The annual reports of the sample companies are checked against disclosure index developed by the researcher. The researcher uses dichotomous score, i.e. one is given if the company discloses the information, and zero for otherwise. Since the annual reports are checked against the disclosure index to provide the disclosure score, during this process, some of the disclosures in the annual reports are not clear for the researcher to decide whether some parts of annual report disclosure represent the items from the disclosure index. Hence, for these confusing items, questionnaire is constructed and sent to the ten accountants and six financial analysts in order to seek their opinions on whether these confusing disclosures in the annual reports represent the items in the disclosure check list. It is found out that there is no significant difference between the score provided by the researcher and the answers provided by the selected accountants and financial analysts. Finally, the weight for each disclosure item is calculated by the mean score of each disclosure item provided by the accountants and financial analysts.

Independent Variables

There are six independent variables which comprise of three structural measures of corporate governance (i.e. board leadership structure, board composition and board size) and three measures of ownership structure (i.e. director ownership, institutional ownership, and block ownership). Finally, the empirical model of the study also includes two control variables related to firm-specific characteristics (i.e. firm size and leverage). The complete empirical model is as follow.

$$Y_{it} = \beta_o + \beta_1 x_{1it} + \beta_2 x_{2it} - \beta_3 x_{3it} - \beta_4 x_{4it} + \beta_5 x_{5it} + \beta_6 x_{6it} + \beta_7 x_{7it} + \beta_8 x_{8it} + \mu_{it}$$

Where,

i = 1,2,3,4,5,6,7,8,9,10,11,12

t=1, 2, 3, 4, 5,6,7,8,9,10

Y= Weighted financial information disclosure score

x_1= Board leadership structure (BLS)

x_2= Proportion of independent non-executive directors on the board (INE_BZ)

x_3= Board size (BZ)

x_4= Proportion of director ownership (DOWN)

x_5= Proportion of institutional ownership (IOWN)

x_6= Proportion of block ownership (BOWN)

x_7= Log of total assets (TA)

x_8= Leverage (TD_TE)

μ= Error term

Sample selection and Statistical Methods

Samples includes the twelve listed companies whose main activity is banking from 1996 until 2005. The sample period covers five years before and after Corporate Governance was introduced in 2001. The total number of observations is 120 observations. However, some of the observations need to be dropped due to unavailability of data and some companies were not classified as banks in all the ten years' period. It left the final observations to 108 observations. Data were collected either from the annual reports of the companies or from Bloomberg. The statistical method used in this study is robust regression.

4.0 Profile of the Respondents

Overall, both male and female respondents seem to be equally distributed since forty nine percent of the respondents are male and fifty one percent of them are female. Regarding educational background, the majority of them are bachelor degree holders, and the balances are professional certificate holders. Since fifty seven percent of the respondents are from the audit firms and forty three percent of them are from the non-audit firms, the opinion seems not to be too much influenced by one particular group although majority of the respondents are accountants. The age range of the majority is between twenty and twenty nine, followed by the age range between thirty and thirty nine. In terms of working experience, majority of the respondents, i.e. forty three percent, are below three years in the current profession and twenty three percent of them have working experience between three to seven years.

Table 1:Profile of respondents

	Accountants		Financial analysts		Overall	
	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Gender						
Male	52	39.69	37.00	72.55	89.00	48.90
Female	79	60.31	14.00	27.45	93.00	51.10
Total	131	100.00	51.00	100.00	182.00	100.00
Educational background						
Bachelor degree	74	56.92	25.00	50.00	99.00	55.00
Master	6	4.62	19.00	38.00	25.00	13.89
Ph.D			1.00	2.00	1.00	0.56
Professional qualification (ACCA, CIMA, CFA, etc)	50	38.46	5.00	10.00	55.00	30.56
Total	130	100.00	50.00	100.00	180.00	100.00
Employment category						
Audit firm	103	78.63	1.00	1.96	104.00	57.14
Non-audit firm	28	21.37	50.00	98.04	78.00	42.86
Total	131	100.00	51.00	100.00	182.00	100.00
Age range						
Below 20						
20 – 29	63	48.09	11.00	21.57	74.00	40.66
30-39	35	26.72	22.00	43.14	57.00	31.32
40-49	27	20.61	14.00	27.45	41.00	22.53
50-59	4	3.05	4.00	7.84	8.00	4.40
60 and above	2	1.53			2.00	1.10
Total	131	100.00	51.00	100.00	182.00	100.00
Working experience with current profession						
Below 3 years	63.00	48.09	15.00	29.41	78.00	42.86
3 – 7	29.00	22.14	13.00	25.49	42.00	23.08
8 – 12	16.00	12.21	10.00	19.61	26.00	14.29
13 – 17	15.00	11.45	7.00	13.73	22.00	12.09
18 – 22	2.00	1.53	3.00	5.88	5.00	2.75
23 – 27	2.00	1.53	3.00	5.88	5.00	2.75
Above 27	4.00	3.05			4.00	2.20
Total	131.00	100.00	51.00	100.00	182.00	100.00
Additional information						
Masters			1.00	1.96	1.00	0.55
Professional qualifications (ACCA, CIMA, CFA, etc)	15.00	11.45	7.00	13.73	22.00	12.09

5.0 Discussion on the Results

Table 2 shows the descriptive statistics of the variables used in the study. In case of board leadership structure, its mean value (0.81) shows that a majority of the companies have separate leadership structure although the minimum value (zero) shows that there are companies which have combined leadership structure. Similar to the recommendation of the MCCG (2001), the sample mean value (0.36) shows that ratio of independent directors is slightly more than one

third of the total number of the directors. The mean value (8.23) of board size shows existence of a quite a reasonable board size, e.g. Jensen and Ruback (1983) suggest that a board size of not more than 7 or 8 members is considered reasonable in ensuring effectiveness. For ownership, the mean values of director ownership and institutional ownership are 0.02 and 0.17 respectively. The ownership of shares by directors can be considered very low where, on average, only 2 percent of shares owned by the directors. On the other hand, institutional investors, on average, owned 17 percent of shares which could still be considered low although it is significantly higher than the ownership by the directors. In the case of block ownership, its mean value (0.53) shows that the significant portion of the shares is owned by large shareholders. The mean value of weighted financial disclosure score is 182.34. As for the firm-specific characteristics, the sample companies have the means values of RM45992.19 millions for total assets and 344.73 for the ratio of total debt to total equity.

Table 2
Descriptive statistics: Independent, dependent and control variables

	Mean	Std. Dev.	Min	Median	Max	Skewness	Kurtosis
Independent variables							
(a) CG variables							
BLS	0.81	0.40	0.00	1.00	1.00	-1.57	0.46
INE_BZ	0.36	0.18	0.10	0.33	0.83	0.68	-0.49
BZ	8.23	2.34	4.00	8.00	14.00	0.33	-0.62
(b) Ownership variables							
DOWN	0.02	0.05	0.00	0.00	0.25	3.26	10.40
IOWN	0.17	0.18	0.00	0.09	0.64	1.00	-0.53
BOWN	0.53	0.21	0.00	0.58	1.00	-0.81	0.04
Dependent variable							
(e) Disclosure variable							
WDS	182.34	17.01	145.78	168.35	189.41	-0.78	0.70
Control variables							
TA	45992.19	40245.92	1120.36	33326.95	191895.30	1.54	2.28
TD_TE	344.73	331.14	14.03	223.80	1442.26	1.60	1.89

Note: WDS refers to weighted financial information disclosure score.

Table 3 shows the results on disclosure of financial information. BLS, INE_BZ (at 1% Sig. level), BZ and IOWN (at 5% Sig. level) are in line with hypothesis while the rest are not. Thus, it can be generally concluded that separate board leadership structure, higher proportion of

independent directors on the board, smaller board size, higher director ownership, higher institutional ownership and lower block ownership have higher financial information disclosure.

Table 3

GLS results of disclosure: Financial information

	Coefficient	Z_value	P value
Independent variables			
BLS	3.23	0.74	0.46
INE_BZ	**18.54**	**3.52***	**0.00**
BZ	-0.06	-0.11	0.91
DOWN	4.86	0.12	0.90
IOWN	**26.65**	**2.25****	**0.02**
BOWN	-4.21	-0.87	0.38
Control variables			
LNTA	**16.02**	**5.9***	**0.00**
TD_TE	**-0.02**	**-3***	**0.00**
CONS	-32.92	-1.47	0.14
Chi-Sq. P value			**4493.86*** **0.00**
Heteroskedastic (LR Test)	LR Chi^2 P value		**64.78*** **0.00**
Autocorrelation (Wooldridge Test)	F statistics P value		**13.61*** **0.00**
* Significant at 1% ** Significant at 5%			

6.0 Conclusion and Area for Future Research

In summary, this study examines whether better corporate governance can contribute towards higher financial information disclosure. The sample consists of 12 banks listed on Bursa Malaysia for the periods of 5 years pre and post introducing of the Malaysian Code on Corporate Governance (2011). The findings of panel data regression show that separate board leadership structure, higher proportion of independent directors on the board, smaller board size, higher director ownership, higher institutional ownership and lower block ownership have higher financial information disclosure. Hence, for future research, it can be extended by interviewing the board to directors about their perceptions towards financial information disclosure and compare with the actual financial disclosure in the annual report. In addition, the researchers

should consider other corporate governance variables which might influence the banks to disclose more financial information disclosure.

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