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The Determinants of Relevant Information Disclosure: A Corporate Governance Perspective[1]

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ABSTRACT

The main objective of this study is to explore empirically the corporate governance mechanisms in UAE that may affect the extent to which relevant information (i.e., forward-looking information) is disclosed. Narrative sections of company annual reports (mainly chairmen's statements/ management or directors' reports) for each company were examined. This study utilizes a sample of firms that are listed in either the Dubai Financial Market or the Abu Dubai Securities Market. It uses the accounting and market data available for 2007-2009. The results of this study show that the institutional investors, governmental investors, ownership (less than 10%), ownership (more than 10%), and the debt ratio have a significant impact on the level of relevant information disclosure. This study concludes that three of the corporate governance mechanisms [i.e., institutional investors; ownership (> 10%); debt ratio] have a negative impact on the level forward-looking information disclosure; whereas the governmental investors and ownership (5-10%) are found to have a positive effect on the level of forward-looking information disclosure.

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INTRODUCTION

This study examines the association between selected variables of corporate governance mechanisms and the disclosure of information in corporate annual reports. It focuses on value-relevant information (i.e., forward-looking information) which has strong effect on all parties' decisions specially investors. Such information is voluntarily published in annual report narratives of UAE companies. The same for the corporate governance code where there are no compulsory rules for UAE companies to follow before April 2010. This makes the study important and relevant to those who want to know the association between corporate governance mechanisms and the level of relevant information disclosure. It is suggested that corporate governance mechanisms have a positive relationship with the forward-looking information. A number of studies provide evidence that corporate governance mechanisms lead to a high level of disclosure which considers as a signal for achieving transparency. Disclosing forward- looking information is necessary for different users who need to know more relevant information about companies' future perspectives (Preston, Wright, and Young, 1996).

The importance of this study comes from the severe incidents happened in 1998 and 2006 in the United Arab Emirates (UAE) which leads to huge financial losses. This is because there was insufficient relevant information that different stakeholders depend on to make appropriate decisions. Aljifri and Hussainey (2007) reveal that the level of disclosing relevant information is low in the listed companies in UAE in 2004.

This study will add to the small literature in this area in three aspects. First, the methodology used in this study improves the accuracy of scoring the forward-looking information by replacing the softwares (e.g. NUDIST), that have been used in the literature (Hussainey, 2003, and Aljifri and Hussainey, 2007), with the manual content analysis. This approach reduces the level of confusion that could result from vague sentences which the softwares can't not capture. Second, it is the first study to examine the relationship between corporate governance mechanisms and forward-looking information in a developing country like UAE. Finally, even if this study applies to UAE, its results can be used by those countries that have similar socio-economic and political environments.

PRIOR RESEARCH AND HYPOTHESES

The main aim for this study is examine the key factors affecting forward-looking reporting in UAE. This section explores prior research relevant to our investigation and the related hypotheses. The research objective of this study is synthesized from the following two strands of literature. The first is related to the association between corporate governance and voluntary disclosures. The second focuses on the effect of firm characteristics on corporate voluntary disclosures.

Corporate Governance and Voluntary Disclosures

The present paper uses a set of corporate governance mechanisms that are more likely to affect forward-looking information in UAE annual reports. In particular, it focus on institutional investors, governmental investors, block-shareholders, board size and dividend policy as potential drivers for UAE companies decision to include forward-looking information in their annual reports. Next paragraphs discuss the development the research hypothesis for each governance mechanism.

Institutional investors (i.e. banks, finance companies, insurance companies) are considered as the key players in the financial markets. They are the main collectors of savings and suppliers of funds to financial markets. Due to their large ownership stake, agency theory suggests that institutional investors have strong incentives to monitor companies' disclosure practices, as they often undertake an active role in monitoring management's performance (Jensen and Meckling, 1976). Consequently, extent research on the association between institutional investors and voluntary disclosure suggests that the higher the concentration of institutional ownership in a company, the higher the managers' motivation to disclose more voluntary disclosure in order to maintain investors' confidence in the company (El-Gazzar, 1998). Empirical research on the determinants of voluntary disclosure finds the expected positive relationship between institutional investors and voluntary disclosure in general (Mitchell et al., 1995; Bushee and Noe, 2000; Barako et al., 2006) and forward-looking disclosure in particular (Lakhal, 2005; Hussainey and Wang, 2011).[2] The positive association between voluntary disclosure and institutional ownership suggests that it may be costly for the company with a large number of institutional shareholders to disseminate forward-looking information to them through direct

[2] Lakhal (2005) finds a positive relationship between forward-looking disclosure and 'foreign' institutions only, but insignificant association between local/French institutions and forward-looking disclosure.

meetings. To a certain extent, these companies might consider the annual reports as the most efficient communication tool for conveying their forward looking information to their institutional investors. Based on the agency theory and the above-mentioned empirical research, we formulate our first research hypothesis as follows:

H1: *There is a positive association between institutional investors and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

Governmental investors are considered as one of the key participants in the stock market especially in the developing countries. Agency theory suggests that agency costs of government-owned companies are relatively high (Samaha and Dahawy, 2011). One natural response by these companies is to increase their level of voluntary disclosure in order to reduce any information asymmetry between managers and the owners. In addition, Makhija and Patton (2004) argue that government is likely ro hold a large equity stake in the newly provatized firms because the palns were to complete the firm's privatization at a later time. Therefore, they expect that the government would prefer more disclosure by the firm in order to maximise its share value in the stock market. Due to the fact that government-owned companies are more visible to the public, extent empirical research finds that government-owned companies voluntarily disclose more information than non-government-owned companies (Eng and Mak, 2003; Abd-Elsalam and Weetman, 2003; Hassan et al., 2006). Based on the agency theory and the above-mentioned studies, we formulate our second hypothesis as follows:

H2: *There is a positive association between governmental investors and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

Block shareholding ownership is referred to a situation in which a shareholder has an exceptionally large percentage of shares in a company (i.e. shareholdings of 5% or more). Agency theory suggests that firms with a dispersed ownership of shares (i.e. investors who own only a small percentage of shares in a company) will disclose more information to satisfy their investors' needs (Marston and Polei, 2004). On the other hand, investors with large stake in a company can obtain the needed information from their direct communication with the company (i.e. direct meeting with managers). As a result, a negative association between block-shareholdings and voluntary disclosure is expected. Prior research on the determinants of voluntary disclosure finds a negative association between block shareholding and voluntary disclosure (McKinnon and Dalimunthe, 1993; Schadewitz and Blevins, 1998; Marston and Polei, 2004; Haniffa and Cooke, 2002; Samaha and Dahawy, 2011; Samaha et al, 2011). Based on the agency theory and the above-mentioned studies, we formulate our third and fourth hypotheses as follows:

H3: *There is a positive association between block-shareholders who own 5%-10% of shares and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

H4: *There is a negative association between block-shareholders who own greater than 10% of shares and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

Board size represents the total number of executive and non-executive directors on the board of directors as of the annual meeting date during each fiscal year. Prior research on the association between board size and voluntary disclosure is mixed. On one hand extent literature argues that large boards may be ineffective and hence less likely to be involved in the decision-making processes such as the decision to improve voluntary disclosure levels (Goodstein et al., 1994). In addition, Jensen (1993) and Yermack (1996) argue that communication and coordination related problems exist in large boards and negatively affect their effectiveness. They also argue that small boards are found to be more effective in monitoring the firm's managers. Empirical research on the determinants of voluntary disclosure finds a negative relationship between board size and voluntary disclosure in general (Willekens et al., 2005; Arcay and Vazquez, 2005; Cheng and Courtenay, 2006) and forward-looking information in particular (Lakhal, 2005).

On the other hand, prior corporate governance literature shows that larger boards are more effective (Willekens et al., 2005), and transparency is considered an indicator of effective boards of directors (Van Den Berghe and Levrau, 2004). Empirical research on the determinants of voluntary disclosure finds a positive association between board size and voluntary disclosure in general (Barako et al., 2006; Laksamana, 2008) and forward-looking information in particular (Hussainey and Al-Najjar, 2011; Hussainey and Wang, 2011). Based on the above mixed results, we formulate the fifth hypothesis as follows:

H5: *There is an association between board size and the extent of forward-looking information in annual report narrative sections of UAE companies.*

Dividend policy is one of the key determinants of corporate disclosure. Dividend is considered as a key mechanism for reducing agency costs and also it substitute the outside directorship on the board of directors (Al-Najjar and Hussainey, 2009). The association between dividend policy and forward-looking disclosure has received much attention in prior research. Hussainey and Walker (2009) find that forward-looking disclosure and dividends are substitute forms of communicating value-relevant information to investors. As explained by These findings are in line with signaling theory which suggests that firms with higher levels of asymmetric information (i.e. lower levels of future-oriented information) are more likely to pay higher levels of dividends to signal their future prospects to current and potential investors (Deshmukh, 2005). However, these findings are not in line with pecking order theory which suggests that firms with higher levels of asymmetric information (i.e. lower levels of future-oriented information) are more likely to be underinvested. To control the underinvestment situation, these firms are more likely to lower their dividends. Research in the developed countries finds a positive association between information asymmetry and dividends which is consistent with signaling theory. Using the number of analysts following firms as a proxy for information asymmetry, Deshmukh (2003, 2005) and Li and Zhao (2008) find that dividend payments are lower in US firms with more information asymmetry. In addition, Basiddiq and Hussainey (2011) find a negative association between asymmetric information and UK dividend policy. Using levels of voluntary disclosure as a proxy for information asymmetry, Hussainey and Al-Najjar (2011) and Hussainey and Wang (2011) find a positive association between dividends and level of forward-looking information in annual report narrative sections. In the present paper, we test to see which theory supports the association between dividend payments and forward-looking disclosure in UAE. Therefore, we formulate the sixth hypothesis as follows:

H6: *There is an association between dividend payout and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

DISCLOSURE AND FIRM-SPECIFIC CHARACTERISTICS

In the present study, we examine the effect of three firm-specific characteristics on forward-looking disclosure. In particular, we examine the extent to which firm size, debt ratio and profitability affect the firms' decision to voluntarily disclose forward-looking information in annual reports narrative sections.

Firm size is one of the most widely used variables in prior research on determinants of corporate reporting. Signalling theory proposes a positive relationship between voluntary disclosure and firm size. The theory suggests that large firms attract more analysts and are subject to greater demand for value-relevant information by analysts and their investors. Additionally, large firms have sufficient funds to cover the cost of producing information for annual reports users (Hassan et al., 2006), while small firms may suffer from competitive disadvantages if they increase levels of voluntary disclosure (Alsaeed, 2006). Prior empirical studies consistently find a positive association between levels of disclosure and firm size (Firth, 1979; Lang and Lundholm, 1993; Hossain et al., 1995; Hassan et al., 2006; Alsaeed, 2006). This indicates that larger companies follow better disclosure practices (Ahmed and Courtis, 1999). On the other hand, it could be argued that managers of large firms have incentives for reducing the level of disclosure, more specifically the level of forward-looking information, to avoid litigation costs (Field et al., 2005). In this case, a negative association between disclosure and forward-looking information could be hypothesis. In a UAE context, Aljifri and Hussainey (2007) find no association between firm size and forward-looking disclosure. Because of this mixed results, the relation between firm size and forward-looking voluntary disclosure remains an empirical issue to be addressed in the present paper. Therefore, we hypothesise that:

H7: *There is an association between firm size and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

Debt ratio is also expected to be positively related with levels of corporate disclosure based on signalling theory. Jensen and Meckling (1976) argue that highly leveraged firms have higher monitoring costs. A potential response of these highly leveraged firms to reduce these costs is to disclose more forward-looking information in their annual report narratives in order to convey value-relevant information to satisfy creditors' needs. Wallace et al. (1994), Willekens et al. (2005), Aljifri and Hussainey (2007), Barako et al. (2006) and Hussainey and Wang (2011) find a positive association, suggesting that high debt ratio leads to higher risk. Firms are more likely to increase their levels of corporate disclosure. Such increase is expected to reduce financing costs and the required risk premiums in the required rates of return. On the other hand, Alsaeed (2006) argues that creditors may share private information with their debtors and hence less information will be available via the formal financial communication channels (i.e. annual reports). Empirically, Bharath et al (2009) find a positive association between debt ratio and information asymmetry which suggests a negative association between debt ratio and voluntary disclosure (taking into account the fact that voluntary disclosure and information asymmetry are negatively associated). Because of this mixed results, the relation between debt ratio and forward-looking voluntary disclosure remains an empirical issue to be addressed in the present paper. Therefore, we hypothesise that:

H8: *There is an association between debt ratio and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

Profitability is one of the potential drivers of voluntary disclosure. Signalling theory suggests that profitable firms have an incentive to disclose more information to signal their favourable results to stock market participants. Therefore, one can anticipate that profitable firms are more likely to disclose forward-looking information in their annual report narratives. In their meta-analysis, Ahmed and Courtis (1999) find that the empirical evidence on the association between disclosures and profitability is mixed. For example, Li et al (2008) find a positive association between profitability and voluntary disclosure, while Celik et al. (2006), Hoitash et al. (2009) and Hussainey and Al-Najjar (2011) find a negative association between the two variables. It worth noting that Schleicher et al. (2007) find that the publication of forward-looking information in annual report narrative sections is considered a key source of information for unprofitable firms, but not for profitable firms. Therefore, one could anticipate that unprofitable firms will be motivated to disclosure more forward-looking information. In the UAE context, Aljifri and Hussainey (2007) find a negative association between profitability and forward-looking disclosure. Based on these arguments and in line with Aljifri and Hussainey (2007), we formulate the seventh hypothesis as follows:

H9: *There is a negative association between profitability and the extent of forward-looking disclosure in annual report narrative sections of UAE companies.*

METHODOLOGY

Data collection

Date were collected for the annual reports published in years 2007-2009 for the listed companied in UAE companies listed in the Dubai financial market and the Abu Dhabi securities market. The reason for choosing the years 2007-2009 is because that the first draft of corporate governance was released in 2006 which motivate the listed companies to start implementing it. It is believed that most of the companies begin to improve more their corporate governance mechanisms voluntarily starting from 2007, although these mechanisms were employed by the companies earlier than 2006. The research methodology is designed based on the study of Aljifri and Hussainey (2007).

Manual Content Analysis

Each annual report was examined manually and this approach is different from the one that has been used in previous literature (Aljifri and Hussainey, 2007, and Hussainey, 2008). In prior literature researchers have used different softwares (e.g., NUDIST) to capture the forward looking information. The reason of selecting the manual content analysis is because of its accuracy (Henry and Leone, 2009). Two factors motivate us to follow the manual content analysis: (1) the short section (chairman's report) that contains the relevant information, and (2) the small number of the sample study. This creates more flexibility to read all relevant sections carefully and make sure to capture all relevant information included in annual reports.

To determine the forward-looking information sentences, this study follows the same list of keywords used by Hussainey *et al.* (2003) and Aljifri and Hussainey (2007). The keywords are: accelerate, anticipate, await, coming (financial) year(s), coming months, confidence (or confident), convince, (current) financial year, envisage, estimate, eventual, expect, forecast, forthcoming, hope, intend (or intention), likely (or unlikely), look forward (or look ahead), next, novel, optimistic, outlook, planned (or planning), predict, prospect, remain, renew, scope for (or scope to), shall, shortly, should, soon, will, well placed (or well positioned), year(s) ahead. These keywords imply financial and non-financial information such as next's year earnings, expected revenues, anticipated cash flows, current/expected risks, and uncertainties. Only those sentences that their contexts refer to look-forward looking information are captured.

To avoid any subjectivity in this process four research assistants and the authors involve in reading the relevant annual reports (i.e., chairman's sections).

The Model

The extent of disclosure was measured as the ratio of the value of the number of forward-looking sentences a firm discloses divided by the total sentences in its narrative sections.

The disclosure index can be shown as follows:

$$TDS = FWD / TD \tag{1}$$

where: TDS = Total disclosure score

FWD = Total forward-looking sentences disclosed

TD = Maximum sentences disclosed for each company

A multiple regression model was used to examine the above hypotheses of this study. The model explains the effect of some selected corporate governance mechanisms on the level of forward-looking information disclosure. The model is stated as follows:

$$\mathbf{TDS} = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9$$

(2)

where:

X_1 = Institutional investors

X_2 = Governmental investors

X_3 = Ownership (5-10%)

X_4 = Ownership (10%)

X_5 = Board size

X_6 = Dividends payouts

X_7 = Firm size

X_8 = Debt equity ratio

X_9 = Profitability

RESULTS

Table 1 presents the contribution of explanatory variables to the model through the regression coefficients and their p-values. The table reveals that five variables are found to have significant effect on the level of forward-looking information disclosure. These variables are the institutional investors ($p < 0.05$), the governmental investors ($p < 0.05$), ownership, less and more than 10%, ($p < 0.05$), and the debt ratio ($p < 0.05$). Three of these variables [i.e., institutional investors; ownership (> 10%); debt ratio] are found to have a negative impact on the level forward-looking information disclosure. However, the governmental investors and ownership (5-10%) are found to have a positive effect on the level of forward-looking information disclosure.

For the other variables (firm size; dividends payouts; board size; profitability), the results reveal that these variables have no significant effect on the level of forward-looking information disclosure.

Table 1: Determinants of Forward-looking Disclosures

Descriptions	unstandardized Coefficients	Sig. *P* value
(Constant)	.337	.444
Firm size	.086	.106
Dividends payouts	-.008	.101
Institutional Investors	-.217	.023
Governmental Investors	.409	.020
Ownership (5-10%)	.183	.017
Ownership (> 10%)	-.261	.018
Board size	-.024	.159
Debt ratio	-1.861	.027
Profitability	-1.422	.079

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