CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

This chapter reviews corporate governance and it's evolution in Malaysia and numerous important studies carried out pertaining to disclosure of information in corporate annual reports. Then the study will simply move on to probe further if there is any association or relationship between the results from the unweighted disclosure index and selected corporate governance attributes.

2.2 Corporate Governance and Malaysian Corporate Performance

The Asian Financial Crisis that caused huge wreckage throughout the East Asian region was truly a reflection of corporate governance failure. In fact the President of the Institute of Chartered Accountants in England and Wales (ICAEW) in a speech given at one of the ICAEW Council meetings commented, "Behind every headline case is a failure of corporate governance". Several decades of flourishing and booming economies saw the stock markets plummeting to an all time low, corporate profitability dipping, foreign currency exchange rates dropping and the economy being at it's ugliest with inflation, high unemployment rates, riots and unrests.

In Malaysia the KLSE Composite Index, which was 1237.96 in 1996 had depreciated to a meager level of 594.44 in 1997. The market capitalization too had depreciated by 53% from RM 806.8 billion in 1996 to RM 375.8 billion in 1997. After more than five years since the devastation the composite index as at 2002 was at 646.32 whilst the market capitalization had settled at RM 481.6 billion. The US$ - RM which had always been in the range of US$ 1 to RM 2.50 to RM 2.60 prior to the crisis had depreciated to more than RM 4.50. This had resulted in the foreign exchange reserves of the country to slide to US$ 20,013 million in 1996 from US$ 26,156 in 1997. The Government of Malaysia had to intervene by introducing several capital control measures in September 1998 including pegging the RM to the US Dollar at 3.80.

Table 2.1: Key Economic Indicators

	1996	1997	1998	1999	2000	2001
KLSE Composite Index	1237.96	594.44	586.13	812.33	679.64	696.09
Real GDP (RM Billion)	130.6	140.7	182.3	192.8	209.4	210.5
Growth of GDP (%)	8.6	7.7	-7.5	5.8	8.3	0.4

Source: *Bank Negara Malaysia Annual Economic Report*

Several professional studies and surveys on corporate governance practices on Asian economies have been carried out over the past few years. One such study by McKinsey in 2002 reiterated that a significant majority of investors are willing to pay a premium as high as 30% for shares of a well-governed company. Another recent study of global emerging markets by Credit Lyonnais Securities Asia concluded that better corporate governance would eventually yield better bottom lines.

It is truly unfortunate that we all needed a crisis such as this to highlight inefficient disclosure policies and poor governance standards. The reform process which begun almost immediately in Malaysia comprised of two major types that is a financial sector reform and a capital market reform. The financial sector reform was intended to aid the ailing banking sector by injecting funds to acquire non-performing banking loans and to facilitate the out-of-court settlement of corporate debts. With the capital market reforms several measures were taken solely to strengthen investors protection and promote investors confidence and one of the measures is by enhancing the standards of corporate governance. (Mohnot R)

2.3 Evolution of the Malaysian Code of Corporate Governance

The work to strengthen corporate governance standards in Malaysia had begun long before the Asian Financial Crisis 1997-1998 impacted the Southeast Asian region. In fact it was an important activity in the Securities Commission's phased program to move to a disclosure-based regulation (DBR) from the former merit-based regulation (which began in 1995). The SC upon its establishment in 1993 had inherited the Merit-Based Regulation (MBR) as it's regulatory philosophy. In 1996 the SC had already embarked on a 3-phased shift plan from MBR to DBR.

A report from a survey jointly conducted by PricewaterhouseCoopers and the SC in July 2002 had quoted as follows:

> "***Disclosure*** *is crucial to investors who wish to invest or have invested in securities. In disclosing information, it is imperative that companies undertake a* ***due diligence*** *process to ensure that all information disclosed is full, timely and accurate.* ***Corporate governance*** *is the process and structure used to direct and manage the business and affairs of the company towards business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interest of other stakeholders."*

The three crucial components of DBR is thus disclosure, due diligence and corporate governance collectively known as the three tenets of DBR. However growing complexity of capital markets, the corporate carnage created by the Asian Financial Crisis and the recent spate of corporate calamities had forced the Ministry Of Finance to expedite the shift plan. As part of this exercise in March 1998, it formed a Finance Committee, which will look into establishing a framework for corporate governance and setting best practices for the industry. The Finance Committee completed its task and submitted it's final report on 8th February 1999.

The Government finally announced acceptance of the Code a month later. On 1st June 2000 The Kuala Lumpur Stock Exchange (KLSE) mandated the inclusion of a corporate governance statement in the annual reports of all listed companies. The Deputy Secretary-General in the Ministry of Finance had commented in announcing the acceptance, those deficiencies, which had prompted the government to react. Firstly there are many companies with large shareholders who exercise control rights where the risk of the minority shareholders being expropriated exists. Secondly there exists a general skepticism about the ability of boards. Thirdly is the passivity of shareholders and fourthly lacking of enforcement. Lastly there is lacking of awareness of responsibilities amongst boards. The weaknesses identified above were the focal area of work for the Committee.

2.3.1 Content of the Code

The Code is basically divided into two sections. The first section identifies the need for the Code as a self-regulatory approach to raising standards in corporate governance; sets out the necessary prerequisites to encourage compliance with the Code; identifies the principal parties to whom the Code is directed at; and discusses the approach, form and content of the Code most suited to the Malaysian corporate landscape (Page 57 Chapter 5 of Code). Meanwhile section 2 sets out the proposed Code directed principally at boards of public listed companies. The Code in essence covers four broad areas namely Directors, Directors' Remuneration, Shareholders and Accountability and Audit.

2.3.2 Related Developments

A joint survey by Pricewaterhouse & Coopers and KLSE reaffirmed that concerted efforts taken by Malaysian regulators and market participants to strengthen corporate governance standards has not been futile effort. In fact a comparison with a benchmark 1998 survey indicated that the CG gap between Malaysia and its developed peers in the region such as Singapore, Hong Kong and Australia has narrowed. However there is still plenty of room for improvement.

One of the recent measures taken to overcome the problem of shareholders' passivity is the formation of the Minority Shareholders Watchdog Group (MSWG). The Employee Provident Fund (EPF) has taken a lead role in this cause. Various steps have also been taken to ensure that company directors and affected parties are aware and understand their responsibilities in the new environment of greater transparency. An important step in this direction is the new requirement under the KLSE Listing Requirements for directors of public-listed companies to be accredited with the Research Institute of Investment Analyst Malaysia (RIIAM) under its Mandatory Accreditation Programme.

A recent survey (McKinsey, 2002) indicated that a significant majority of investors highlighted significant corporate governance changes that have been made over the last five years include enhanced disclosures, adoption of best practices code and improved corporate legislations.

2.4 Disclosure and Disclosure Studies

Over the past four decades or so the issue of corporate disclosure practices has received a considerable amount of attention from researchers worldwide. Some researchers attempt to link extent of voluntary disclosure with firm-specific characteristics [Hossain et al (1994)], Tan et al (1990), Chow and Wong-Boren (1987), Raffournier (1995)]. Other researchers try and associate the extent of voluntary disclosure practices with other factors such as security risk measures (Firth, 1984), cost of equity capital (Botosan, 1997), analysts behavior (Lang & Lundholm, 1996) and even cost of debt (Senguptha, 1998). Some researchers dwell into the reasons for some firms to voluntarily disclose bad news (Skinner, 1994) or factors, which may induce a company to disclose more information (Meek et al 1995).

2.4.1 Definition of Voluntary and Mandatory Disclosures

Parker (1992) defined disclosure as "the reporting of information (both financial and non-financial) to users of accounting reports, especially to investors". There are two types of disclosures. Mandatory disclosures are disclosures made in compliance to local legislations and binding accounting standards whereas voluntary disclosures are any disclosures in excess of those mandatorily required.

Several studies have indicated that the concept of disclosure is significant to a free economy as allocation of resources by a market is based upon the assumption that inadequate disclosure will create ignorance in the securities market and thus lead to a misallocation of resources in the economy. (Barret, 1975 & Rahman A, 2001). The unpublished study by Rahman (2001) also discovered that the level of disclosure in Malaysia in terms of mandatory and voluntary has improved over the twenty-year period from 1974 to 1994 with mandatory disclosure showing a substantial increase and voluntary disclosure showing a marginal increase.

Besides accounting policies, presentation and timeliness of reporting, disclosure is a very important variable in determining the quality of accounting (Marston & Robson, 1997). There are numerous means that a company can choose to disseminate information to its wide array of users but one of the most common routes is by using an annual report. Botosan(1997, 329) stated that although an annual report is only one means of corporate reporting but it should serve as a good proxy for the level of voluntary disclosure provided by firms across all disclosure avenues. Thus the annual report will be the focus of the disclosure index since it is generally considered to be one of the most important sources of corporate information.

2.4.2 Different Methods of Measuring Disclosures

A useful way of ascertaining the quality of disclosure is by using a disclosure index that satisfies the reliability and validity criteria. The use of index has been adopted by many researchers in the past as well as in recent years e.g. Singhvi & Desai (1971), Firth (1984), Tan et al. (1990), Haniffa & Cooke (1990), Meek et al (1995), Raffournier (1995), Schadewitz & Blevins (1998), Eng & Mak (2002), Ho & Wong (2001), Rahman A (2001) and Ferguson et al.(2002).

Some researchers have attempted to measure the disclosure level in different countries and then make a comparison (Barrett, 1975 and Meek et al 1995). Another example such as this was a study carried out to compare the annual reports of airlines in four countries in the Pacific Rim to assess the extent and usefulness of voluntary disclosure (Isa, 1997). The writer discovered that the quality of disclosure in Malaysia and Singapore was comparatively greater than in Australia and New Zealand.

On the other hand some other researchers have attempted to look at changes over time in studying the trend in disclosure level over the years (Barrett, 1975 and Rahman, 2001). One such example is Rahman who empirically examined the extent of disclosures in the 1974, 1984, and 1994 annual reports of 54 listed companies in Malaysia and the relationship between a number of corporate attributes. So far a majority of disclosure studies to date have been focusing at disclosures at a particular point in time. One reason for the apparent lack of a longitudinal type of study may be the practical problems in obtaining annual reports for a large enough sample of companies going back over several years (Marston & Robson, 1997 pg 114).

2.5 Development of Disclosure Index

As mentioned earlier disclosure index is a useful way in measuring disclosure quality and has been adopted in several studies so far. An index is built by basically determining a group of items that represents either mandatory or voluntary disclosure items. From thereon the extent and quality of disclosure in corporate annual reports is measured. As far as past researchers are concerned these items can either be determined based on survey of user groups or review of relevant literature. Common items in an index include the following classification of items:-

- General corporate information
- Corporate strategy
- Management discussion and analysis
- Employee information
- Projected information
- Summary of important financial statistics
- Financial ratios
- Value added information
- Shareholding

Developing the disclosure index based on survey of user groups will result in a *weighted disclosure index* as in studies by Singhvi & Desai(1971), Firth(1984), Tan et al.(1990), Eng & Mak(2002), Schadewitz & Blevins(1998) and Ho & Wong(2001).

A disclosure index with 34 items was constructed by Singhvi & Desai (1971) to evaluate the quality of information disclosed. This index was based on the index developed by Cerf in 1961. Then based on interviews with several experts in the field of investment and security analysts, weights were allocated to note the relative importance of each item.

Another disclosure index was developed by Firth (1984) consisting of a list of 48 items of information that could appear in corporate annual reports, identified after reviewing some accounting literature. Two criteria were used in preparing i.e. first exclude items required by statute or regulations and secondly the item was such that it could disclose if it desires. Weightage is then attached to the item after obtaining feedback from financial analysts who were requested to grade the importance of each item.

Tan et al. (1990) selected a list of information items that corporations may want to disclose based on three criteria. The first was to exclude items mandatorily required by statutory regulation. Secondly items pertaining to corporations with significant interest in manufacturing or industrial activities without extractive operations were included. Lastly there must be reasonable potential for inter-firm variability in presenting the items in the annual report. The final list of 25 items was presented to a group of financial analysts for evaluation of importance.

122 annual reports were reviewed by Botosan(1997) to arrive at a disclosure index guided by recommendations provided in several accounting literature and survey of investor information needs. The index was divided into five sections that is background information, summary of historical results, key non-financial statistics, projected information, and management discussion and analysis. To overcome the problem that large firms could score higher points as a result of more disclosure opportunities due to the complexity of the organizational structures Botosan suggested two steps. Firstly earnings and sales for the year was consolidated hence companies with multi-segment will earn full score only if they provide a forecast for all segments. Secondly points were not awarded to multiple references to the same disclosure items.

Just like Botosan, Eng, Hong & Ho(2001) too studied the link between financial statement disclosure and the cost of equity capital. For this purpose they also constructed a disclosure index, which was similar to the disclosure index developed by Botosan (1997). This disclosure index was followed in Eng & Mak's (2002) study.

The method employed in the above studies notes distinction in the relative importance of each item to the users of annual report (Singhvi & Desai, 1971) but it contains an inherent degree of uncertainty and subjectivity. Thus *unweighted disclosure index* is particularly appropriate when "user preferences are unknown, different classes of users are likely to assign different weights to similar items" [Meek et al (1995), Hossain et al(1994) and Ferguson et al.(2002)]. An item, which may be of utmost importance to one, may not be important to another. A study by Chow and Wong-Boren(1987) also reports that there is not much of a significant difference between using weighted and unweighted index. Furthermore it may tend to favor a particular set of users (Raffournier, 1995). Due to the above reasons the unweighted disclosure index is chosen for purpose of carrying out this study.

An *unweighted disclosure index* adopts a simple dichotomous procedure by allocating a score of 1 for disclosure of an item and 0 for non-disclosure as in studies by Meek et al(1995), Raffournier(1995), Rahman A(2001), Ferguson et al.(2002) and Haniffa & Cooke(2000). In other words every information item carries equal importance for all users of annual report.

A voluntary disclosure checklist with 128 items was later checked to respective national disclosure requirements of the respective companies in the sample in a study by Meek et al(1995). The final checklist consists of eighty-five items of information.

Raffournier(1995) used a list of 30 items derived from Fourth and Seventh EC Directives as financial disclosure in Switzerland was largely discretionary. The items were segregated under the heading "items for company" and "additional items for disclosing consolidated statements".

A list of disclosure items for mandatory and voluntary disclosure using five criterion such as past review of relevant research studies, items statutorily required, items desirably disclosed, items disclosed by companies that won the National Annual Corporate Reports Award (NACRA) and items deemed disclosed regardless of its' industry was developed by Rahman (2001). Based on these criterions, 202 items were finally listed to form the aggregate index.

Ferguson, Lam & Lee(2002) identified a voluntary disclosure index of 102 potential items based on researches carried out by Meek et al(1995) and Hossain et al.(1995). The final disclosure index was trimmed down to 93 items.

Based on the indices developed by Hossain et al.(1995) and Soh (1996), Haniffa & Cooke(2000) prepared a score sheet for voluntary disclosure of 65 items. For each company the disclosure index is measured as the ratio of the actual score obtained over the maximum possible score appropriate or relevant to the company. This score will then be associated with some attributes such as firm-specific, corporate governance and personal. Lastly this will be treated as factors, which will be determinants for voluntary information disclosure. The table in Appendix 1 refers to some of the studies, which were referred to in developing the disclosure index.

2.6 Determinants of Corporate Voluntary Disclosure

The dependent variable in this study is voluntary disclosure and many factors are known to be its' determinants such as economy, capital markets, accounting and regulatory framework, enforcement mechanisms and culture. (Haniffa & Cooke, 2000)

A majority of past studies in the area of voluntary disclosure focused on firm specific attributes or corporate attributes. Some of the commonly used explanatory variables in this area are firm size, leverage, liquidity, type of auditor, and scope of business. Recently as a result of corporate governance emerging as an issue of global significance many studies have diverted the focus to areas that relate to corporate governance attributes.

Probably one of the earlier researches relating to several corporate governance attributes and the extent of voluntary disclosure in Malaysia long before corporate governance was given much emphasis was by Haniffa & Cooke(2000). They investigated whether corporate governance and personal attributes in addition to company-specific characteristics are possible determinants of voluntary disclosure in Malaysia. The results indicated potential significance of two corporate governance variables (chairman who is a non-executive director and ratio of family members on board).

Four major corporate governance attributes was linked to the extent of voluntary disclosure provided by listed firms in Hong Kong in a study by Ho & Wong (2001). The attributes are the proportion of independent directors to total number of directors on the board, the existence of a voluntary audit committee, the existence of dominant personalities and the percentage of family members on board. They concluded that existence of audit committee is significantly and positively related to the extent of voluntary disclosure whereas the percentage of family members on board is negatively related to the extent of voluntary disclosure.

When examining the association between independent non-executive directors and family control to the extent of financial disclosures in Hong Kong, Chen & Jaggi (2000) revealed findings that there was a positive association between comprehensive financial disclosures and the proportion of independent non-executive directors.

Eng & Mak (2001) in a study of *158 firms* listed on the Singapore Stock Exchange find factors such as managerial ownership, government's ownership, Board of Directors firms, and leverage as factors influencing disclosure.

G.Mani (2002) replicated this study by using a similar disclosure index for *30 Indian firms* listed on the Bombay Stock Exchange for the year 2001-2002 and examined the impact of independent directors, block holding, leverage, firm size and Foreign Institutional Investors on corporate disclosure. The results were that independent directors were found to influence voluntary disclosures much more as compared to block holding ownership. A weak significance of size was also predicted.

Chau & Gray (2002) examined the association of ownership structure and corporate voluntary disclosure in Singapore and Hong Kong and revealed findings that the extent of outside ownership is positively associated with voluntary disclosures.

On the basis of all the past researches carried out above this study will be focusing on the following corporate governance attributes: -

- Proportion of independent non-executive directors
- Chairpersons who are also CEOs
- Proportion of family members on board

The selection of the variables above was based on an extensive review of literature on the above-mentioned attributes.

2.6 Summary

Researches on disclosures and attributes such as firm-specific characteristics have been carried out all this while by numerous researchers in various parts of the world. Similarly in Malaysia, researches in this area have been quite a common topic of interest amongst local academicians. However, empirical evidence on the relationship between voluntary disclosure and corporate governance attributes are rather limited. Haniffa & Cooke (1990) were one of the pioneers in carrying out a research in this area. This study intends to contribute to the limited knowledge base that exists locally. The next chapter will provide details on sources and types of data involved, sample selection, data collection methods as well as statistical tests, which will be used in the study.