City University Research Journal
Volume 08 Number 02 July 2018 PP 155-167

THE IMPACT OF CORPORATE GOVERNANCE ON VOLUNTARY DISCLOSURE: EVIDENCE FROM PAKISTAN

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ABSTRACT

This study examines the impact of corporate governance on voluntary disclosure of manufacturing companies listed on Pakistan Stock Exchange. The study uses probability sampling technique for selecting firms from each stratum randomly. Sample size consists of 62 manufacturing firms listed on Pakistan Stock Exchange from 2013 to 2015. The eventual inferences have been drawn using correlation and multiple regression techniques. Results show that corporate governance influences voluntary disclosure. Specifically, the magnitude of the audit committee and the duality of Chief Executive Officer are very influential. The study suggests that firms in emerging economies like Pakistan need to increase the number of audit committee members and avoid duality of holding the positions of chairman and chief executive officer for higher voluntary disclosure which will ultimately improve firms' performance. This study contributes to the existing literature by investigating the impact of most suitable corporate governance characteristics on voluntary disclosure especially with regard to Pakistan. Based on the existing literature, no such study has been conducted in Pakistan.

Keywords: Corporate governance, Voluntary disclosure, Pakistan, Audit committee, Chief Executives Officer.

INTRODUCTION

The concept of corporate governance (CG) got popularity in the previous decades due to the East Asian crises of the 1990s, financial crises 2007-08 and major corporate scandals occurred in business giants such as Enron, WorldCom, and Tyco. CG consists of practices and institutions such as laws and accounting standards regarding disclosure of financial position, compensation of executive directors, board size and board composition (Javid & Iqbal, 2010). However, the structure of effective CG is in debate for a long time (Mulili & Wong, 2011). Cutting and Kauzim (2002) argued that comprehensive CG structure needs to include independent directors, consideration of executive directors' remuneration and reducing the power of Chief Executive Officers (CEOs). For the better structure of CG and improvement of firms' financial performance, firms need to look at the CEO's position and power (Arcay & Zquez, 2005). CG builds the relationship among various stakeholders such as the board of directors, management, and shareholders. According to Adawi & Rawegasira (2011), for firms to attract more capital and minimize the cost of capital, good CG is necessary. CG must ensure transparency and disclosure. If a firm wants to be trusted, must disclose required information to their stakeholders continuously.

Disclosure is considered as an important element of CG which provides enough information to all stakeholders for making rational decisions. It also ensures that board of directors and managers of the company work for maximization of the shareholders' wealth. It also prevents fraudulent actions of firms (Adawi & Rawegasira, 2011). Disclosure of information in annual report may be mandatory[1] or voluntary[2]. It is necessary to disclose information voluntarily as mandatory disclosure provide only

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those information which is required by law and regulatory authorities. Therefore, it does not fulfill the requirements of various stakeholders. In order to compete in this age of globalization, firms need to provide adequate information to their stakeholders. Adequate information makes it possible to minimize the information gap between executives and investors (Al-Janadi, Rahman, & Omar, 2011). Providing adequate information is also important because it provides a complete picture of opportunities and risk involved in an investment.

Scandals, frauds, and corruption in the corporate world occurred mainly because of fraudulent practices of CG such as misreporting in financial statements, window dressing, accounting manipulation, violation of laws and exploitation of stakeholders' interests. Weak CG leads the economy to suffer huge losses. Pakistan's economy also faced corporate frauds and scandals. Few examples are Taj Company, Crescent Bank and Pakistan Telecommunication Company Limited (PTCL). The government of Pakistan takes several steps to reduce such frauds by promoting good CG practices. Code of CG adopted by Securities and Exchange Commission of Pakistan (SECP) in 2002 is considered as the basic steps towards making CG more effective and efficient in Pakistan. Code of CG is the result of joint efforts by SECP, Institute of Cost and Management Accountants of Pakistan (ICMAP) and Pakistan Stock Exchange (PSX). CG in Pakistan is an evolutionary process and SECP, as well as State Bank of Pakistan (SBP), are involved in improving CG according to the global trends. In order to promote CG, Government of Pakistan established Pakistan Institute of Corporate Governance (PICG) providing guidelines for governing corporations and help them absorb changes in the corporate world.

LITERATURE REVIEW

Empirical Studies

Many studies in the past examined the relationship between CG and information disclosure (for example Arcy & Vazquez, 2005; Barako, Hancock, & Izan, 2006; Bauwhede & Willekens, 2008; Goodstien, Gautam, & Boeker, 1994). Al-Janadi, Rahman, & Omar (2013) found a positive relationship of board size, CEO duality, a high ratio of non executive directors and quality of audit with voluntary disclosure. Fathi (2013) found that a firm's level of disclosure is explained by CEO duality, the concentration of ownership, quality control and a number of auditors. Examining the impact of CG practices on voluntary disclosure, using 35 Nigerian listed companies for 11 years from 1999 to 2009 and employing multiple regression model, Damagum and Chima (2013) found that board size significantly influences voluntary disclosure.

Nandi and Ghosh (2012) found that family control on business, the duality of CEO and board size positively influence corporate disclosure whereas the relationship of board composition with voluntary disclosure was negatively affecting voluntary disclosure. Aboagya-Otchere, Bedi, & Kwakye (2012) empirically tested CG influence on disclosure of companies listed in Ghana Stock Exchange and found that firms' size and audit committee were positively associated with firms' disclosure level whereas no relationship between composition of audit committee, non executive directors on board, leverage and ownership structure were found with firms' disclosures level.

Previous studies (Allegrini & Greco, 2011; Arcy & Vazquez, 2005; Haniffa & Cooke, 2000; Khodadadi, Khazami, & Aflatooni, 2010) found a positive impact of many CG practices such as board size, number of audit committee meetings, size of institutional investors' ownership and family dominated boards on voluntary disclosure.

Conceptual Framework

The conceptual framework given in figure 1 below is drawn on the basis of relevant literature. Arrows in the figure show the impact of all independent variables on the dependent variable.

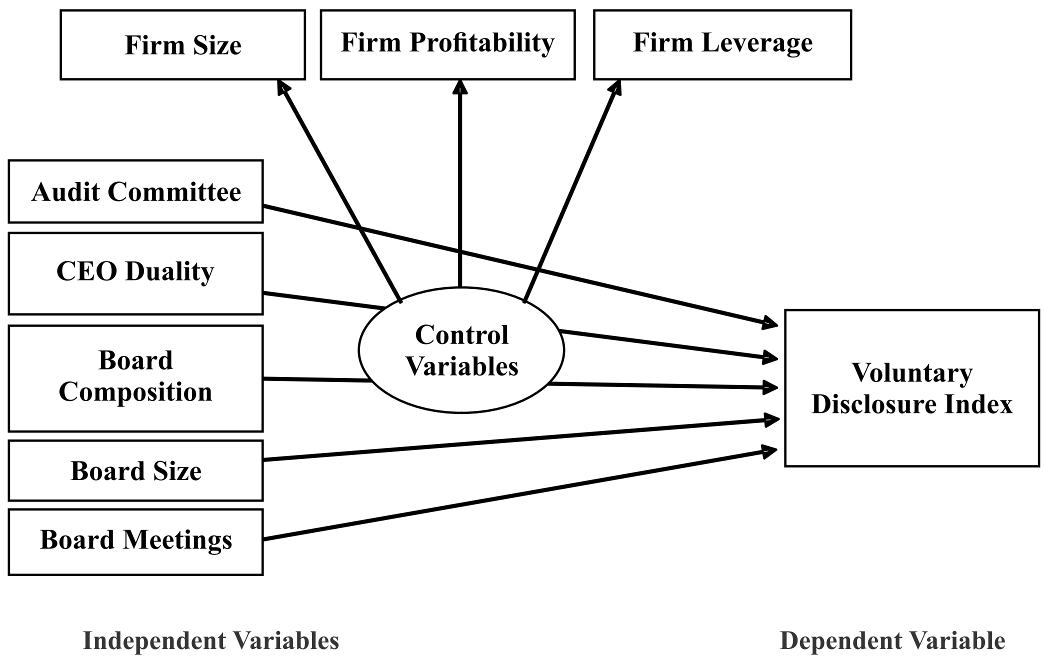

Figure 1: Conceptual framework

Theoretical Background and hypotheses development

Theoretical background of the CG and voluntary disclosure can be found in agency and information asymmetry theories. Previous studies used agency theory as a theoretical framework to test CG, company-specific characteristics and voluntary disclosure hypotheses (Cheng & Courtenay, 2006; Gul & Leung, 2004). Agency theory discusses principal and agent relationship. The interests of principal and agent are quite different from each other. A party having more information than other is known as information asymmetry (Watts & Zimmermen, 1978). Management having more information while shareholders or investors are less aware of company activities and that is why makes poor decision to allocate their investment. The problem of information asymmetry can be reduced for the investor through voluntary disclosure (Grossman, 1981).

Main characteristics of CG include transparency and enough disclosure of information. Klai and Omri (2011) stated a strong correlation between CG and financial information reporting. In order to reduce the information asymmetry among company's stakeholders, financial reporting discloses adequate information about the financial position and economic situation of the company (Whittington, 1993).

Audit Committee

Agency problem and information asymmetry can be minimized through the establishment of an effective audit committee. Audit committees are employed in a situation of high agency cost as a monitoring mechanism to get a better flow of information between principal and agent (Pincus,

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Rusbarsky, & Wong, 1989). Less information asymmetry was found among the shareholders and managers of firms having an audit committee (Collier, 1993). The audit committee has a positive relationship with voluntary disclosure. Therefore, the establishment of an audit committee is necessary for the transparent business activities (Ho & Wong, 2001). Accurate forecasting by managers of firms is possible through efficient audit committee (Vafeas, 2005). The audit committee is considered as a monitoring tool to improve external financial report reviewing and auditing (Bradbury, 1990). In order to make financial reports more qualitative, firms need to have minimum three members in their audit committee (Vafeas, 2005). As such our first hypothesis to be tested is developed as under:

H1: An audit committee having a large number of members has a significant positive influence on voluntary disclosure.

CEO Duality

Duality means a director having charge of both CEO and chairman of the board (Rechner & Dalton, 1991). Previous studies (Allegrini & Greco, 2011; Daily & Dalton, 1994; Forker, 1992; Gul & Leung, 2004; Jenson, 1993; Lakhal, 2005; Rechner & Dalton, 1991) have different views regarding CEO duality and voluntary disclosures. Daily and Dalton (1994) argued in the context of agency theory that the directors possessed a high level of independence to monitor and evaluate the CEO when chairman and CEO position are separated. Separation of CEO and chairman functions of the firm are necessary for the purpose of reducing agency problems and increasing transparency (Jenson, 1993). Firms having CEO duality will disclose less information (Forker, 1992). Chairman not having the role of CEO will increase the firm's performance (Rechner & Dalton, 1991). CEO acting also as a chairman may not disclose important information to outsiders and give rise to agency problems (Gul & Leung, 2004) therefore; CEO and chairman need to be separated. Lakhal (2005) also found that CEO duality has a negative association with earning disclosure voluntarily and suggested that CEO and chairman position need to be separated for higher disclosure, transparency, and credibility. Allegrini and Greco (2011) found a negative relationship and confirmed that dual position with one person reduces the volume of information disclosures. As such the second hypothesis to be tested is as under:

H2: CEO duality has a significant negative influence on voluntary disclosure.

Board Composition

Board composition plays an important role in mitigating agency problems. Previous studies report mixed results. Board consists of a larger number of directors as independent non-executive is related to low voluntary disclosure (Gul & Leung, 2004). Ho and Wong (2001) argued that there is no relationship between board having external directors and voluntary disclosure. Several other studies confirmed that non-executive directors and voluntary disclosure have a positive relationship (Arcay & Vazquez, 2005; Cheng & Courteny, 2006). Firms having independent directors reduce agency problems and protect shareholders' rights (Anderson & Reeb, 2004). A board having more independent directors provide a higher voluntary disclosure which reduces information asymmetry (Lim, Matolcsy, & Chow, 2007). For the efficient and effective CG, firms need to have a large number of directors as independent on their board (Fama & Jenson, 1983). Thus, the third hypothesis to test is given below:

H3: a Higher proportion of non-executive directors has a significant positive influence on voluntary disclosure.

Board Size

Board size is considered an important practice of CG. Several studies examined the relationship between board size and voluntary disclosure and reported contradictory results. Many studies (Ahmed, Hossain, & Adams, 2006; Goodstein et al., 1994; Jenson, 1993) found that a board with large size is expected to have less monitoring ability and thus provide less corporate disclosure. On the other hand, Barako et al. (2006) found a positive relationship between board size and disclosure. In other words, boards with larger size lead to higher level of disclosure. Cheng & Courtenay (2006) found no correlation between board size and non-mandatory disclosure. According to Laksmana (2008), large boards bring both financial and managerial diversification. Our fourth hypothesis is as under:

H4: Large boards have a significant positive influence on voluntary disclosure.

Board Meetings

Providing an opportunity for exchanging ideas about monitoring of the managers, meetings are considered as vital. According to Lipton & Lorsch (1992), the main challenge being faced by directors to complete board activities effectively is the lack of time. Board meetings are considered important measures of board activities (Vafeas, 1999). A higher level of board monitoring increases firms' value and help to provide different opportunities for investment (Brick & Chidambaran, 2010). Previous studies (Allegrini & Greco, 2011; Laksmana, 2008; Vafeas, 1999) found a positive relationship between the frequency of board meetings and voluntary disclosure suggesting holding board meetings frequently to facilitate the flow of information among directors and to maximize board effectiveness. As such the fifth hypothesis to be tested is given below:

H5: Higher frequency of board meetings has a significant positive influence on voluntary disclosure.

RESEARCH METHODOLOGY

Research Design

This study uses causal correlational research design which is considered as most effective to examine the influence of CG attributes on voluntary disclosure of manufacturing firms in Pakistan. According to Hsiao (1985), there are several benefits of panel data which include sample variability, reduction of multicollinearity, elimination of estimation bias and correct inferences as such the study uses panel data which observe the entities across time.

Target Population

The target population of current study consists of all manufacturing firms listed on PSX for 2013-2015. In total, 578 companies are currently listed on PSX classified into 35 different sectors on the basis of their characteristics and nature of the business.

Sample Size and Sampling Techniques

Using stratified random sampling technique, a sample of 62 manufacturing firms listed on PSX for the period 2013-2015 has been selected representing 16 percent of total population making 186

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observations.

Sources of Data

Data have been collected from annual reports and audited financial statements of sample firms. These reports were downloaded from the official websites of companies, PSX, and SECP.

Data Analysis Techniques

The collected data from annual reports and audited financial statements were arranged in Microsoft Excel. The data were then entered into SPSS and Eviews for generating results. Multiple regression analysis was then employed to examine the data. Hypotheses of the study were tested through T-test, F-test, and P-value. Regression model equation of the study is given below.

Regression model

VDI=α+β1AC+β2CEOD+β3BC+β4BS+β5BM+β6FS+β7FP+β8LEV+e

Where

VDI =Voluntary disclosure index,	α = Alpha (Y Intercept)
β = Slope coefficient,	AC=Audit committee
CEOD= CEO duality,	BC = Board composition
BS=Board size,	BM=Board meeting
FS=Firm size,	FP=Firm profitability
LEV=Leverage.	e = error term

Voluntary Disclosure Index

Following previous studies (Hossian & Hammami, 2009; Najm-ul-sehar, Bilal, & Tufail, 2013), this study uses voluntary disclosure index (VDI) as the dependent variable. While developing VDI for this study, some items were excluded from keeping in view the Pakistani corporate sector limiting the final checklist to 35 items. The study followed dichotomous unweighted approach to score the voluntary disclosure of firms. This approach is popular in literature and used by several studies both in less developed and developed countries (Cooke, 1989; Haniffa & Cooke, 2000; Hossian & Hammami, 2009; Meek, Roberts, & Gray, 1995). Under this method, “1” is used if an item is disclosed in the annual report and “0” if otherwise.

Variables of the Study

Table 1 presents variables used in the study along with its symbols and measurement techniques.

Table No: 1 Variables of the study

Concept	Variables	Symbols	Measurement
Dependent Variable Voluntary Disclosu re	Voluntary Disclosure Index	VDI	The score obtained by firm divided by maximum Score

Independent Variables Corporate Governance(CG)	Audit Committee	AC	Number of audit committee members
	CEO Duality	CEOD	Dummy variable 1 for dual & 0 for not dual
	Board Composition	BC	The ratio of nonexecutive directors to the total Board size
	Board Size	BS	Total number of board members of the firm
	Board Meeting	BM	Number of board meetings
Control Variables Firm Specific Characteristics	Firm Size	FS	Natural log of total assets
	Firm Profitability	FP	Return on equity
	Leverage	LEV	Debt ratio

RESULTS AND DISCUSSION

Descriptive Statistics

Table 2 shows descriptive statistics for all variables used in the study. The study uses a checklist of 35 items to measure voluntary disclosure of manufacturing companies. The maximum proportionate value of voluntary disclosure in the entire sample is 91 percent and the average percentage value is 54. This indicates that the company's disclosure score goes to 91 percent and disclose most of the checklist items in their annual reports. While the minimum score value is 23 percent which means that some companies disclose 23 percent of disclosure checklist items in annual reports. Descriptive statistics indicate an average size of the board and audit committee as 4 and 8 respectively. CEO duality has an average value of .1129 indicating a very low ratio in Pakistani firms. Statistics of board composition show that an average number of non-executive directors on the board is 70.11 percent whereas maximum value is 93 percent and minimum 38 percent. A number of board meetings range from 2 to 16.

Table No: 2 Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Std. Deviation
VDI	186	.23	.91	.5407	.16719
AC	186	3	7	3.4892	.80027
CEOD	186	0	1	.1129	.31733
BC	186	.38	.93	.7011	.13867
BS	186	5	15	8.1183	1.59289
BM	186	2	16	5.0806	1.69545
FS	186	16.10	27.04	22.4769	1.69040
FP	186	-69.96	5.60	-.2234	5.19732
LEV	186	0	4.7	.6572	.52421
Valid N (List wise)	186				

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CORRELATION ANALYSIS

Table 3 indicates correlation analysis.

Table No: 3 Correlation Analysis

Variables	VDI	AC	CEOD	BC	BS	BM	FS	FP	LEV
VDI Pearson correlation	1	.456**	-.214**	.267**	.354**	.208**	.678**	.039	.013
Sig. (2-tailed)		.000	.003	.000	.000	.004	.000	.598	.863
N		186	186	186	186	186	186	186	186

**correlation is significant at the 0.01 level (2-tailed): *correlation is significant at the 0.05 level (2-tailed)

Multivariate Analysis

The study uses multiple regression analysis to examine the impact of CG on voluntary disclosure. All the required assumptions of regression model have been satisfied.

Diagnostics

Variance Inflation Factor (VIF) and tolerance values are used to determine whether multicollinearity problem exists or not. These are considered as the most effective methods to test for multicollinearity in the regression model. As a rule of thumb, VIF value greater than 10 indicates existence of multicollinearity problem whereas less than 10 shows no multicollinearity problem (O'Brien, 2007). VIF and Tolerance values for all independent variables are reported in table 4.

Table No: 4 Collinearity Statistics

Variables	Tolerance	VIF
Audit committee	.695	1.439
CEO duality	.954	1.048
Board composition	.837	1.194
Board size	.671	1.490
Board meeting	.821	1.218
Firm size	.677	1.477
Firm profitability	.986	1.015
Leverage	.975	1.026

As shown in table 4, VIF and Tolerance values for all the independent variables are less than 10 and 2 respectively suggesting nonexistence of multicollinearity problem.

In order to check heteroskedasticity, the study uses Breucsch-Pagan-Godfrey test (Breusch & Pagan, 1979). There is no heteroskedasticity if p-value against observed R square under Breusch Pagan Godfrey test is more than 0.05 ($p > .05$). Since p-value shows in table 5 against observed R square is 0.50 ($p > .05$), there exists no problem of heteroskedasticity.

Table No: 5 Heteroskedasticity Test: Breusch-Pagan-Godfrey

F-statistic	0.898000	Prob. F(8,177)	0.5194
Obs*R-squared	7.254830	Prob. Chi-Square(8)	0.5094
Scaled explained SS	8.235155	Prob. Chi-Square(8)	0.4108

Model Summary

The model summary is given in table 6. Adjusted R-Square is .504 indicating 50.4 percent change in the dependent variable due to change in all independent variables used in the study. F-value is 24.483 and statistically significant at .000 which means that model is best fit and suitable to measure the population parameter.

Table No: 6 Model Summary

R	.725
R-Square	.525
Adj R-Square	.504
F-Statistics	24.483
Sig	.000

REGRESSION RESULTS

Regression results are provided in table 7. As reported in table 7, C value of -.943 indicates a 94 percent negative variation in the dependent variable. It is statistically significant at 5% confidence level. The coefficient of AC is .039 which means that one percent change in AC brings 3.90 percent variation in voluntary disclosure. Therefore, the hypothesis 1 that 'audit committee impact voluntary disclosure' has been accepted. The result is consistent with the previous studies (Madi, Ishak, & Manaf, 2014; Persons, 2008). The coefficient of CEO duality of -.079 indicates the negative relationship of CEO duality with voluntary disclosure significant at 1% supporting our hypothesis 2 stating that CEO duality has a negative influence on voluntary disclosure. The result is consistent with previous studies (Forker, 1992; Lakhal, 2005). Board composition's coefficient of .075 shows that change of one percent in board composition brings 7.50 percent change in the dependent variable however statistically insignificant. Therefore, our hypothesis 3 that proportion of non-executive directors has a significant influence on voluntary disclosure is rejected. This result is same as the study of (Ho & Wong, 2001). The board size' coefficient of -.002 that an increase of one percent in board size reduces voluntary disclosure to the extent of .20 percent, however, the result is statistically insignificant. The same insignificant result was also found by Arcy & Vazquez (2005) in their study. Regression results further show an insignificant negative relationship between the frequency of board meeting and voluntary disclosure. This finding is consistent with the study conducted by Adawi & Rawegasira (2011).

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Table No: 7 Regression Results

Variable	Coefficient	Std.error	T-statistics	P-value
C	-.943	.119	-7.895	.000
AC	.039	.013	3.013	.003
CEOD	-.079	.028	-2.831	.005
BC	.075	.068	1.106	.270
BS	-.002	.007	-.248	.805
BM	-.009	.006	-1.571	.118
FS	.061	.006	9.744	.000
FP	-3.337E-5	.002	-.020	.984
LEV	-.003	.017	-.150	.881
Dependent variable: VDI				Sig at 0.05 levels

Summary of hypotheses

Summary of hypotheses used in the study is presented in table 8 below:

Table No: 8 Summary of Hypotheses

Hypotheses	**Description**	**Outcome**
Hypothesis No.1	An audit committee has a large number of members has a significant positive influence on voluntary disclosure.	Accepted
Hypothesis No.2	CEO duality has a significant negative influence on voluntary disclosure.	Accepted
Hypothesis No.3	A h igher proportion of non -executive directors has a significant positive influence on voluntary disclosure.	Rejected
Hypothesis No.4	Large boards have a significant positive influence on voluntary disclosure.	Rejected
Hypothesis No.5	Higher frequency of board meetings has a significant positive influence on voluntary disclosure.	Rejected

CONCLUSION AND RECOMMENDATIONS

For the purpose of this study, 62 firms were selected as a sample from manufacturing sector of Pakistan. Multiple regression is used to determine the impact of CG on voluntary disclosure. Results show that CG practices affect voluntary disclosure in manufacturing firms. Audit committee significantly affects voluntary disclosure. Therefore, for the purpose to increase disclosure and transparency, an audit committee's size and frequency of its meetings are more important. Audit committee reduces agency problems by providing higher voluntary disclosure leading to improvement of firms' performance. Results also show the significant negative impact of CEO duality on voluntary disclosure. Therefore, for the purpose of higher disclosure, the separation between holding the positions of CEO and chairman of the board is necessary. Results further show no significant impact of board composition, the frequency of board meetings and board size on voluntary disclosure in manufacturing firms of Pakistan.

Findings of this study may not be generalized to other sectors, however, based on the resemblance of Pakistani corporate environment and CG practices, , the results of the study may have much impact in in manufacturing sectors of other developing countries. Since the study uses only five CG practices being practiced in the manufacturing sector, future research is suggested to seek impact of CG on voluntary disclosure in financial and non-financial as well as manufacturing and nonmanufacturing sectors using more CG practices based on large samples.

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