Voluntary Disclosure of Corporate Governance Practices by Listed Australian Companies

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This study examines the relationship between the voluntary disclosure of information about corporate governance practices and the intention to raise external finance. This relationship is examined by using corporate governance disclosures in the annual reports of Australian companies in 1994. Data from this year are used because in subsequent years Australian Stock Exchange regulations influenced listed companies to make disclosures about their corporate governance practices. Regression analysis indicates that the voluntary disclosure of corporate governance information is positively associated with the intention to raise equity capital, but not with the intention to raise debt capital.

Keywords: Corporate governance, voluntary disclosure, cost of capital

Introduction

Recent international interest in corporate governance issues has been well-documented. Norburn *et al.* (2000) identify 12 significant corporate governance reform initiatives across seven nations since the Treadway Commission report was published in 1987. Such initiatives are likely to be, in part, a response to corporate raids and failures, to the globalisation of capital markets, and to a related perceived need to restore or strengthen investor confidence (Cadbury, 1997; Norburn *et al.*, 2000; Labelle, 2002). Most reform initiatives focus on developing codes of conduct or best practice guidelines for corporate governance, and their status tends to be voluntary, with varying incentives or requirements for organisations to publicly disclose details of their corporate governance practices.

The purpose of this research is to examine the corporate governance disclosure practices of listed Australian companies at a time prior to when mandatory requirements for disclosure were introduced. We examine possible motivations for the voluntary disclosure of governance information, and propose and estimate a model that links disclosures about governance to future financing intentions. It is useful for regulators and others interested in corporate governance to understand the propensity of companies to disclose information about corporate governance practices in the absence of institutional requirements to do so.

The paper is structured as follows. In the next section we review evidence supporting the existence of diversity in corporate governance disclosure practices, and we review the development of governance disclosure requirements in Australia. We then review research into voluntary disclosure in order to form expectations about the incentives for firms to voluntarily disclose corporate governance information. The research method is outlined, followed by the presentation of our findings. The paper concludes with a discussion of the results, followed by an outline of the limitations of the research.

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Diversity in corporate governance disclosure practices

Jackson and Carter liken discretionary corporate governance disclosure decisions to *chiaroscuro* (the management of light and shade in a picture), asserting that "management of what is lit and what remains in the shadows is purposeful, and is done for effect" (1995, p. 1). Similarly Labelle asserts that corporate governance issues have become so significant that it is likely firms use information about them for "impression management" (2002, p. 12). Even where disclosure requirements exist, there is usually substantial latitude afforded managers in relation to the quality and quantity of disclosure about company-specific governance practices (Labelle, 2002).

Empirical evidence is consistent with these claims. For example, Sauer (1996) reports the results of a 1995 survey by the Australian Society of Certified Practicing Accountants in which it was found that 43 per cent of the top 100 listed Australian companies made no specific corporate governance disclosures. A number of companies disclosing corporate governance information for the first time indicated that the practices subject to disclosure had been in place for some time and it was noted that there was considerable diversity in the nature and extent of disclosures that were being made. Labelle (2002) reports the results of a Canadian Institute of Chartered Accountants' study of corporate governance disclosures which concluded that large gaps exist in the disclosures made. Bujaki and McConomy (2002) analysed the Toronto Stock Exchange (TSE) guidelines on corporate governance practices and the disclosure practices of firms affected by those guidelines. They found that very few firms had fully adopted the guidelines and that there was wide variation in the extent of disclosure of corporate governance practices between firms.

Corporate governance disclosure requirements in Australia

The current requirements for disclosure of corporate governance practices in Australia have developed from a reform process that began in the early 1990s. In 1990 Henry Bosch, Chairman of the Australian National Companies and Securities Commission (now the Australian Securities and Investment Commission), chaired a working group made up of members of leading Australian business and professional organisations. This group was formed to "discuss growing public concern about standards of corporate behaviour revealed in recent high profile corporate collapses and to recommend action to promote higher standards of corporate conduct" (Bosch, 1990, p. 4).

The group produced a guide, *Corporate Practices and Conduct*, in 1991 which was revised and reissued in 1993 and 1995. The guide was intended to inform directors, auditors, accountants and investors about principles of good corporate practice and "to spread and reinforce high standards of corporate conduct" (Bosch, 1991, p. 1). As such the guide was concerned more with what constituted good or acceptable practice than with disclosures about those practices. The guide did contain a recommendation, however, that public companies include a statement in their annual reports indicating that they support and adhere to the governance principles set out in the guide. The 1993 edition of the guide contained some relevant examples of wordings that had been used by reporting companies for the benefit of other companies that had not to that point adopted the disclosure recommendation.

The Australian Stock Exchange (ASX) developed Listing Rule 3C(3)(j) (which later became listing rule 4.10) to apply from 30 June 1996. This rule required a listed company to include in its annual report a statement indicating the corporate governance practices that it had followed during the reporting period. The rule was based on a similar rule of the London Stock Exchange that had its origin in the recommendations of the 1992 Cadbury Committee report into corporate governance issues in the UK. The ASX rule did not specify which particular practices had to be reported, but referred to an "indicative" list of items that might be disclosed. As such, it was inevitable that resulting disclosure practices would vary in terms of comprehensiveness and specificity, and the rule attracted criticism for being soft and unenforceable (Carson, 1996, p. 4).

In March 2003, the ASX Corporate Governance Council issued *Principles of Good Corporate Governance and Best Practice Recommendations*, a publication setting out ten essential corporate governance principles, each supported by a set of best practice recommendations. Listing Rule 4.10.3 was amended to require listed companies to disclose a statement in their annual reports which indicates the extent to which they comply with the Council's best practice recommendations. In cases where a recommendation has not been followed, this has to be disclosed, along with the reasons why. This approach to governance disclosure is similar to that adopted by the TSE. It still permits varying degrees of compliance, and variation in the nature and extent of disclosures made.

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Incentives for voluntary disclosure of information by organisations

Healy and Palepu (2001) provide a comprehensive review of the voluntary disclosure literature. They note that research into voluntary disclosure decisions tends to focus on the information role of reporting for capital market participants. They identify five forces that have been found to be related to managers' decisions to voluntarily disclose information for capital market reasons:

- the capital market transactions hypothesis: firm's have incentives to make voluntary disclosures in order to reduce information asymmetry and therefore reduce the cost of external financing through reduced information risk;
- the corporate control contest hypothesis: when corporate performance is poor, managers use voluntary disclosures in an attempt to increase firm valuation and to explain the poor performance, therefore reducing the risk of management job losses;
- the stock compensation hypothesis: managers who are rewarded with stock compensation have an incentive to use voluntary disclosures to reduce the likelihood of insider trading allegations, and firms have incentives to increase disclosures to reduce contracting costs with managers who receive stock compensation;
- the litigation cost hypothesis: managers have an incentive to disclose bad news to avoid legal actions for inadequate disclosure, but have an incentive to decrease disclosures of forecasts that might prove to be inaccurate;
- the proprietary costs hypothesis: voluntary disclosures will be constrained if managers perceive that disclosure could be competitively harmful.

In terms of the voluntary disclosure of corporate governance information in particular, the stock compensation, litigation cost and proprietary cost hypotheses seem to be the least plausible potential explanators of disclosure decisions. Labelle (2002, p. 10) suggests that corporate governance information has minimal proprietary costs associated with its disclosure. It is also difficult to argue convincingly that voluntary corporate governance disclosures might be strongly associated with attempts to avoid litigation through inadequate or inaccurate disclosure, or that insider trading on governance information would be perceived to be significant. While the corporate contest hypothesis is plausible, the capital market hypothesis seems particularly relevant to corporate governance disclosures, and is the focus of this study. If governance initiatives have been developed in response to investor confidence concerns associated with corporate raids, corporate failures and the globalisation of capital markets as was conjectured in the opening discussion, disclosure of governance information could be expected to have positive capital market consequences for the discloser.

Voluntary disclosure and capital market consequences

Consistent with the capital market transactions hypothesis, empirical evidence suggests that, in general, voluntary disclosure is associated with positive capital market outcomes. Richardson and Welker (2001) and Botosan (1997) report an inverse association between disclosure levels and the cost of equity capital for firms with relatively low analyst followings. Sengupta (1998) suggests that bondholders and underwriters do consider corporate disclosure policy when determining the risk premium applicable to interest rates on debt instruments. He finds that lower interest rates are associated with higher levels of disclosure, arguing that greater disclosure lowers perceived default risk, resulting in a lower cost of borrowing. Botosan and Plumlee (2002) find an association between greater annual report disclosure and lower equity capital costs. Thus there is empirical support for the notion that greater disclosure levels, in general, are likely to be associated with access to debt and equity at lower capital costs.

There is also empirical support for the proposition that managers make disclosure decisions in an attempt to take advantage of more favourable terms from capital suppliers. Lang and Lundholm (1993) find that disclosure scores were higher for firms that were issuing securities. Clarkson *et al.* (1999) report that higher disclosure scores in the Management Discussion and Analysis section of annual reports are associated with increases in financing activity. Seppänen's (2000) analysis of disclosure suggests that managers do make disclosures to facilitate capital raisings at a lower capital cost. Hence, there is evidence that an intention to raise funds is one factor that explains managers' decisions to increase voluntary disclosure levels in their annual reports.

The impact of voluntary corporate governance disclosures

There exists ample anecdotal evidence of a link between corporate governance practices and the ability to raise capital on favourable

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terms. MacDonald (1995) asserts that familiar and acceptable corporate governance standards must enhance the capacity of Australian companies to raise equity capital. Sauer (1996) suggests that competition for investment funds is a sound reason for directors to make suitable corporate governance disclosures. Millstein (2000) believes that equity investors make the link between governance practices and investment risk, with effective governance lowering the cost of equity capital. The ASX Corporate Governance Council (2003) claims that being able to demonstrate good governance practices is an increasingly important determinant of the cost of capital in global markets.

There is also a consistent body of survey evidence linking effective governance practices to the raising of capital. Solomon *et al.* (2002) interviewed South Korean institutional investors about the relative importance of directors' motives to reform corporate governance practices. Of 13 reported motives, the most highly ranked was the motive to reduce the perception of risk by investors, banks and credit-rating agencies. Monks (2002) describes the efforts of McKinsey and Company to quantify, through surveys, the value that institutional investors attribute to governance. The results are compelling. One 2002 survey indicates that institutional investors believe that governance accounts for a range of 20–40 per cent of value (Monks, 2002, p. 118). Other results indicate that three-quarters of investors believe board practices to be at least as important as financial performance, with more than 80 per cent indicating that they would pay a premium for a well-governed company (Corporate Board, 2000, p. 27). Further results suggest that investors pursuing growth strategies are prepared to pay an average premium of 11–16 per cent for good governance (Korac-Kakabadse *et al.*, 2001, p. 24).

Despite compelling logical links and survey evidence, there have been very few empirical studies of the relationship between corporate governance disclosure decisions and financing activity or financing terms. Carson (1996) attempts to explain corporate governance disclosure from a sample of Australian companies in 1995 but does not explicitly consider financing motivations. Labelle (2002) investigates the link between governance disclosures and financing but found inconsistent results. Only one result was marginally significant, but it indicated a negative relationship between financing activity and disclosure quality. However, Labelle (2002, p. 32) notes a number of limitations of the study that could have affected the results obtained.

The hypotheses

Given the interest shown by regulators in corporate governance practices, and the disclosure variability that exists even within regulated regimes, it should be of interest to regulators to understand what influences managers' decisions about voluntary disclosure of corporate governance information. The capital market transactions hypothesis provides a plausible explanation. Based on the discussion above, the following expectations concerning voluntary corporate governance disclosure and financing activity are posited:

> *Hypothesis One: In the absence of mandatory requirements to do so, companies are more likely to disclose corporate governance information if they intend to raise new share capital in the year following disclosure.*

> *Hypothesis Two: In the absence of mandatory requirements to do so, companies are more likely to disclose corporate governance information if they intend to raise new debt funds in the year following disclosure.*

Method

Sample

Annual reports of listed Australian companies for 1994 that are included in a Connect 4 database were examined. Connect 4 is an Australian company that specialises in providing information about companies which are listed on the Australian Stock Exchange. There are 299 annual reports in the database for this year. 1994 was chosen as the year for the analysis because we were interested in examining voluntary disclosure of governance information in the absence of institutional or regulatory influences on that disclosure. In September 1994 the ASX (1994) released a discussion paper signalling its intention to introduce Listing Rule 3C(3)(j) to apply from 30 June 1996. This paper encouraged early adoption of the rule and is likely to have influenced firms' disclosure decisions from 1995. Hence our analysis is of annual reports for 1994 year-ends.

Using the search facility in the Connect4 database, a search of these reports was conducted on the words "corporate" and "governance". The word "corporate" was used a large number of times and in different circumstances throughout the reports, so in each case the reference had to be examined to see if it pertained to corporate governance matters even when it was not coupled with the word "governance".

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While companies were not required to disclose information about corporate governance practices in 1994, the Australian Corporations Law at the time did require information about directors of a company to be disclosed. Specifically, s307 required:

1. in relation to each director, their qualifications, experience and any special responsibilities, as well as share holdings in the company and interest in contracts with the company;
2. the number of meetings of the board, and board committees, and how many meetings that individual directors attended.

For the purposes of this study then, since all companies were required to provide this information, it was not considered voluntary disclosure about corporate governance. The search identified 30 companies that made disclosures over and above the statutory requirements. One company was subsequently eliminated from the analysis due to data unavailability. In order to test for differences between disclosers and non-disclosers, a random sample of 75 companies was selected from the remaining companies included in the database in 1994 to form a control group.

The variables

Dependent variable

The dependent variable VOLDIS is a dichotomous variable which takes on the value of 1 if voluntary corporate governance disclosures are made in a firm's annual report and 0 if not.

Independent variables

The hypothesised explanators are a firm's future intentions to issue shares or obtain new debt. In order to provide an incentive for voluntary disclosure, the new issues would need to be non-trivial in size. Consistent with accounting notions of materiality (AASB 1031, para. 4.1.6), we consider a share or debt issue of 5 per cent or more of the existing share or debt level to be non-trivial. The first independent variable, S-ISS takes a value of 1 if the company's issued shares increase by 5 per cent or more in the following financial year. The second independent variable, D-ISS, takes a value of 1 if the company's non-current liabilities increase by 5 per cent or more in the following financial year. Note that while non-current liabilities may include long-term accounts payable and provisions, the 5 per cent filter should ensure that the variable D-ISS only takes a value of 1 when non-trivial new debt issues have occurred.

Control variables

We noted above that the corporate control contest hypothesis was also a potential explanator of decisions to voluntarily disclose corporate governance information. Firms reporting poor performance may have an incentive to disclose governance information (Labelle, 2002). Thus the variable ROA is included to control for this possible effect. ROA is a continuous variable measured as net income divided by total assets as at the end of the reporting year. This measure of performance is consistent with other studies (see Erhardt *et al.*, 2003, p. 106).

Empirical research has identified other variables which have been associated with increased voluntary disclosure in general. Size has consistently been associated with increased disclosure levels (Meek *et al.*, 1995; Williams, 1999; Ho and Wong, 2001; Eng and Mak, 2003). Size is usually measured in terms of total assets or market capitalisation. Because total assets has been used in the calculation of ROA, we measure SIZE as the firm's market capitalisation at balance date to reduce any potential multicollinearity amongst the control variables. Given the magnitude of the dependent variable (0 or 1), SIZE has been deflated by 100 million to be of a similar magnitude.

Industry membership and stock exchange listing status have been found to be associated with voluntary disclosure levels (Meek *et al.*, 1995; Carson, 1996; Williams, 1999; Eng and Mak, 2003). The general argument for industry effects is that firms in more politically visible industries have greater incentives to make voluntary disclosures to improve perceptions about their activities. Consentient with prior Australian research (McKinnon and Dalimunthe, 1993; Mitchell *et al.*, 1995; Aitken *et al.*, 1997), we classify the resources industries, metals, oil and gas and diversified resources as the politically sensitive industries, and measure industry membership with the dichotomous variable IND which takes a value of 1 if the company is a member of a resource industry and 0 otherwise. The final control variable is the dichotomous variable LIST which takes a value of 0 if the company is listed on only the Australian Stock exchange and a value of 1 if the company has multiple listings.

The model

The disclosure decision is a complex and multi-faceted one and it is appropriate to consider the simultaneous effects of the independent and control variables on the disclosure outcome (Labelle, 2002). Thus we estimate the following multivariate model:

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$$VOLDIS = \beta_0 + \beta_1 S\text{-}ISS + \beta_2 D\text{-}ISS + \beta_3 ROA + \beta_4 SIZE + \beta_5 IND + \beta_6 LIST$$

Because of the dichotomous nature of the dependent variable, multinomial logistic regression techniques are used to estimate the model.

Results

Characteristics of the disclosing firms

Of the 29 firms which made voluntary corporate governance disclosures, 10 (34.5 per cent) increased both their issued capital and their non-current liabilities by 5 per cent or more in the subsequent year, 5 (17.2 per cent) increased only their issued capital by 5 per cent or more in the subsequent year, 7 (24.1 per cent) increased only their non-current liabilities by 5 per cent or more in the subsequent year, while 7 (24.1 per cent) increased neither. Eleven firms were from resource industries, six were in the finance and banking sector, six were classified as other industrials, with the remainder being in manufacturing or other service industries.

It is interesting to note that each one of the identified 29 companies not only voluntarily disclosed information about corporate governance, but also highlighted the disclosure within a separate section or sub-section of their annual report. For example, 14 companies had a separate section devoted to corporate governance, seven had a sub-section within the Director's Report, and the remaining eight had a sub-section within some other section such as the Chairman's Report. In 24 of the 29 instances, the heading of the section or sub-section was "Corporate Governance", in four instances it was "Corporate Practice and Conduct", and in the remaining instance it was "Performance and Governance". The amount of information voluntarily disclosed about corporate governance issues varied considerably, from only a few lines of text to almost 50 lines. The categories into which the disclosures fell, and their frequency of disclosure, are reported in Table 1.

Multivariate results

The results of the multinomial regression are presented in Table 2. The overall model was highly significant ($\chi^2 = 25.099$, $p = 0.000$). There was no significant relationship between the voluntary disclosure of corporate governance practices and subsequent increases in debt levels. However, there was a significant relationship between disclosure and subsequent increases in issued capital. Of the control variables, industry membership and multiple stock exchange listings were highly significant, while ROA was marginally significant but not in the expected direction. Size was not significant and its coefficient was in the opposite direction to that expected.

Table 1: Frequency of types of corporate governance information disclosed

Type of disclosure	Number of firms	Percentage of firms
Identification of particular board committees and their functions	23	79.3
The structure of the board (with respect to non-executive directors, for example), how that structure contributes to the board's corporate governance function, whether there is a code of conduct for members of the board, and how members of the board are selected and remunerated	22	75.8
The position that the board of directors takes in general to corporate governance and to the increased focus on this area of corporate activity	21	72.4
Functions of the board with respect to corporate governance	19	65.5
Functions of board committees in general with respect to corporate governance	9	31.0
Internal control policies endorsed by the board, and the function of internal audit within the company	6	20.7
Restrictions on board members with respect to trading in shares of the company	3	10.3

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Table 2: Regression results for predicting corporate governance disclosure

	β	Standard error	Wald statistic	Significance
Intercept	–2.384	0.911	6.843	0.009
Explanatory variables				
Issued shares (S-ISS)	1.059	0.538	3.871	0.049
Issued debt (D-ISS)	0.489	0.522	0.875	0.350
Control variables				
Return on assets (ROA)	7.133	3.954	3.254	0.071
Market capitalisation (SIZE)	–0.014	0.008	2.694	0.101
Industry group (IND)	1.310	0.556	5.562	0.018
Stock exchange listing (LIST)	1.776	0.674	6.954	0.008

Note: Pseudo R-square (Cox and Snell): 21.4%.

Discussion

Our analysis of the 299 annual reports included in the Connect4 database for 1994 revealed that only 30 Australian companies made voluntary corporate governance disclosures. These disclosures varied considerably with respect to the quantity and type of information provided. In this study we predicted that there would be an association between a firm's decision to make voluntary corporate disclosures and its future financing intentions. Our results support this prediction for share issues but not for debt. The number of companies upon which our results are based is small. Nevertheless, subject to this caution, the results are consistent with the capital market transactions hypothesis. They suggest that firms intending to issue shares in the subsequent period have an incentive to make voluntary corporate governance disclosures.

No significant association was found between debt raising intentions and voluntary corporate governance disclosures. This could reflect the nature of the debt market in Australia where there is much greater reliance on private rather than public debt. In her study, Cotter (1998) found that public debt typically constitutes less than 5 per cent of outstanding debt. While the incentive still remains to reduce information asymmetry with respect to risk for debt issues, if the issue is private, the annual report may not be of particular importance in communicating risk-reducing information to the private lender.

Consistent with prior research we also find a significant association between the disclosure decision and industry classification and stock exchange listing status. Firms in the resource industries are significantly more likely to disclose corporate governance information than are members of other industry groups. Similarly, firms with multiple stock exchange listings are more inclined to make disclosures. Performance was found to have a marginal effect on the disclosure decision ($p = 0.071$). However, the relationship was positive which is inconsistent with our expectation under the corporate control contest hypothesis. Labelle (2002) describes the two-way nature of the performance–disclosure relationship, suggesting that firms with good performance are more likely to invest in quality disclosure. This could explain the relationship observed here. It may also be the case that firms generating stronger returns are better placed to invest in governance practices that can subsequently be disclosed.

Limitations

One limitation of this study is that the findings are based on Australian companies which may limit the generalisability of the results to other jurisdictions. The findings are also based on observations of a relatively small number of companies, that is, those listed Australian companies that voluntarily disclosed corporate governance practices in a particular year. This raises further uncertainty about the extent to which the results are generalisable. It is worth noting though, that while the number of companies is small, this does not indicate a failure to use a larger sample. The companies do not constitute a sample but rather they represent the entire population of disclosing companies in that year.

Secondly, as explained above, in order to identify Australian companies that voluntarily disclosed corporate governance practices, it was necessary to use data from 1994. To the extent that the context within which boards make decisions about obtaining equity and debt funds may have changed since then, and

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board motivations and incentives may have evolved, the relevance of the findings may be compromised. Having made that concession, though, it must also be said that there have been no significant changes to the way in which Australian companies seek funds in the debt and equity markets over the last decade. Moreover, given the increased scrutiny of corporate practices today, one would expect that the incentive to signal governance mechanisms suggested by the results of this study are only likely to have been magnified since 1994.

Third, as with all studies of this nature, the variables used are proxies for economic effects or actions that are not directly observed. The extent to which these proxies capture the underlying effects is always unknown and they are thus always subject to issues of measurement noise.

Finally, there may be other variables influencing governance disclosure that have not been included in our model. Thus the possibility of omitted variables and spurious correlations remains.

Conclusion

The findings of this study are consistent with the results of other studies that have linked disclosure decisions to capital market incentives. Specifically, we find evidence that firms choosing to voluntarily disclose corporate governance information behave in a manner consistent with the expectation that such disclosure reduces information asymmetry in capital markets for share issues, and that such disclosures are made in anticipation of pending share issues. As such, this study extends the research into both voluntary disclosure decisions generally and corporate governance disclosures specifically. Subject to the limitations noted above, this study will contribute to and inform the current debate about governance regulation and disclosure by providing evidence that incentives exist for some firms to voluntarily disclose governance information in the absence of a mandatory requirement to do so.

The findings suggest opportunities for further research, as well as issues for regulators to consider. It would be interesting to know if the results can be replicated in other constituencies, especially ones with much larger numbers of reporting entities. It would also be interesting to determine if, consistent with the capital market transactions hypothesis, a relationship can be found to exist between the voluntary disclosure of corporate governance information and the intention to raise debt publicly. Such a study would have to undertaken in the context of a constituency with a sufficiently large number of identifiable public debt issues.

From the point of view of regulators, decisions have to be made about how rigorous and exhaustive disclosure requirements, for example, in relation to corporate governance practices, need to be. These decisions will be informed by an understanding of the motivations that exist to voluntarily disclose such information in certain circumstances. With these insights, regulators must address the question of what disclosures need to be mandated in the absence of such motivations.

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