

## **The effect of Corporate Governance Mechanisms on the Voluntary Disclosure Level**

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#### **الملخص**

يلعب سوق المال دوراً رئيسياً في التنمية الاقتصادية في أي مجتمع من خلال الإفصاح عن المعلومات المتعلقة بالشركات المدرجة في الأسواق المالية بشكل كاف وفي الوقت المناسب. تعتبر حوكمة الشركات والإفصاح من الأدوات الرئيسية لحماية المستثمر وسير العمل في أسواق رأس المال. حيث أن حوكمة الشركات يمكن أن تعزز الرقابة داخل الشركة، و تقلل من السلوكيات الانتهازية وتحد من تماثل المعلومات. يتمثل الهدف العام من هذه الدراسة في قياس تأثير آليات حوكمة الشركات على مستوى الإفصاح الاختياري بهدف جودة التقارير المالية للشركات المسجلة في البورصة.

ويتفرع من هذا الهدف عدة أهداف فرعية تتمثل في (1) ماهى العلاقة بين هيكل مجلس الإدارة ومستوى الإفصاح الاختياري (2) ماهى العلاقة بين المراجع الخارجى ومستوى الإفصاح الاختياري؟ لذا فان هذه الدراسة توضح العلاقة المتداخلة بين اليات الحوكمة ومستوى الإفصاح حيث أن بعض الدراسات أثبتت ان الإفصاح الاختياري الغير جيد يرجع الى التطبيق الغير سليم لقواعد لاليات الحوكمة.

## **Abstract**

This study investigates the extent to which corporate governance mechanisms (board of directors, external auditor) influence on voluntary disclosure of various types of information in Egyptian listed firms. In recent years, the quality of information disclosure in company's annual reports has attracted considerable interest among scholars. Results of prior studies analyzing disclosure level concluded that voluntary disclosure in annual reports is low.

The purpose of this paper is to spot the light on corporate governance mechanisms (board of directors and external auditor) as one of the factors that affecting on voluntary disclosure level in the Egyptian environment. It shows that these mechanisms ensure from voluntary disclosure is implemented according to the required criteria, this results in high financial reporting quality that help investors to use the information disclosed for investment decisions

## **1- Introduction**

Capital markets play a key role in the economic development of any society, through the conversion of savings into effective investments. It is obvious that the owners of savings will not direct their savings towards investment in capital markets unless these markets have the credibility, durability and transparency that make owners have a higher degree of assurance about their savings. The credibility of financial markets can be enhanced through the disclosure of information regarding companies listed in the financial markets adequately and in a timely manner. The role of accounting and auditing profession play in the financial markets complement each other as auditor's work begins where the work of the accountant end. Corporate governance is considered one of the factors that has effect on voluntary disclosure, it provides a framework that can be defined as the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) are directed, administered or controlled(Sharma, 2011).

(Meek, et al, 1995) stated that disclosure can be considered as the process through which an entity communicates with the outside world. There are two streams of disclosure literature, namely voluntary disclosure which defined as disclosures in excess of requirements, representing free choices on the part of company managements to provide accounting and other information to the users of their annual reports .The second type of disclosure is mandatory disclosure that defined as firms that present basic accounting information the minimum required by

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law. Both Mandated and voluntary disclosures reduce information asymmetry among market participants.

Therefore, one stream of research on the field of financial accounting focuses on the relationship between corporate governance mechanisms and voluntary disclosure level.

## **2- Nature of the problem:-**

The wave of accounting scandals occurred in 2001 in the international financial community has raised many criticisms about the financial reporting quality.

In recent years, corporate governance and disclosure are considered as two key inseparable instruments for investor protection and the functioning of the capital markets. Perfect corporate governance can strengthen intra-company control, and can reduce opportunistic behaviors and lower the asymmetry of information, and this will provide high quality of voluntary disclosure which benefits the investors and the firms to enhance financial reporting quality. Corporate governance mechanisms play a vital role to support voluntary disclosure requirements. It ensure that data disclosed in financial reports are correct and accurate to provide assurance to investors and help them to make investment decisions, also governance mechanisms implementations guarantee that voluntary disclosure is made according to required criteria.

So the research problem of this study can be summarized in examining the effect of the corporate governance mechanisms (Board of directors as one of internal mechanisms and external auditor as one of external mechanisms) by showing how these mechanisms guarantees the quality of disclosed accounting

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information and provide financial reports with high quality that help users to make investment decisions.

### **3- Objectives of the study:-**

The overall goal of this study is to investigate the role of corporate governance mechanisms on voluntary disclosure level.

**The following subset also can be proposed to complement the overall goal:-**

1. The effect board of directors as one of the internal governance mechanisms on voluntary disclosure.
2. 2)The impact of external auditoras one of the externalgovernance mechanisms to support voluntary disclosure.

### **4- Research Hypotheses:-**

To achieve the objectives of this study a number of hypotheses have been structed :

**H1-**There is significant relationship between board of directors and voluntary disclosure level for companies in the capital market.

**H2-**There is significant relationship between external auditor and firm's voluntary disclosure level.

**First: Board of director as one of corporate governance mechanisms and its effect on voluntary disclosure level:**

#### **1-Dimensions of Board Performance:**

The board is an effective mechanism of the “decision control” role within a corporation when it is able to restrict the discretion of top managers over the “decision management” role within the corporation.

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Board can be defined according to (McIntyre and Murphy, 2008) “groups of individuals brought together to deal with complex issues in an unstructured fashion in a fluid environment”.

Also (Demirbas and Yukhanaev, 2011) defined boards of directors as sites for “a struggle for hegemony over corporate management between company managers and their countervailing parties represented by large shareholders, who seek to maximize their power and benefits”. In order to understand the effectiveness of the board, it is important to examine dimensions of board performance and organizational performance (Mwenji, and Lewis, 2009).

**The identified dimensions are:**

- A. **Contextual.** Effective boards understand and take into consideration the culture and norms of the organization.
- B. **Educational.** Effective boards ensure that their members are knowledgeable about the organization and the board’s roles, responsibilities, and performance.
- B. **Interpersonal.** Effective boards nurture the development of their members as a working group, attend to the board’s collective welfare, and foster a sense of cohesiveness.
- C. **Analytical.** Effective boards recognize the complexities and subtleties of issues and accept ambiguity and encourage differences of opinion.
- D. **Political.** Effective boards accept as a primary responsibility the need to develop and maintain healthy relationships among major constituencies.
- E. **Strategic.** Effective boards help their organizations envision a direction and shape a strategy for the future. Boards should be viewed as a social system that needs to

be a strong, high functioning work group whose members trust each other.

The researcher argued that the best boards add most value **through five interrelated approaches as following:**

- A. Helping senior management.
- B. Creating opportunities for the president to think aloud.
- C. Encouraging experimentation.
- D. Monitoring progress and performance, and modelling the desired behaviours.

## **2-Responsibilities of the board:**

The board helps to keep the organization close to its mission. The board is able to provide linkages to the organization's major financial backers and brings into the organization different kinds of expertise that are beneficial to the organization.

The board helps the organization to analyse and understand the complex environment under which the organization operates. Also the firm's board of directors (BOD) is an important institution for mitigating the agency problem that arises with absentee ownership.

The board is seen as a monitoring and controlling device whose job it is to review and evaluate the performance of management in running the firm, and is responsible for ensuring that shareholder wealth is maximized and agency problems are minimized.

Also (Donnelly and Mulcahy, 2008) Stated that the directors also are responsible to ensure that the financial and non-financial data are disclosed in the annual reports. The researcher sees that the effective boards of directors play vital

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role in ensuring the appropriate maintenance of corporate governance standards.

The board of directors of the companies is considered an important tool to protect shareholders' assets and to control the management of the company. The board of directors is also the main policy making body, strategic planner, and acts as the authority of the company. The board also provides better transparency in the annual reports.

## **Board of director's characteristics and its effect on Voluntary Disclosure Level**

### **3.1 Board Size:**

(Akhtaruddin, 2009) stated that board size is the number of executive and non-executive directors on the company's board. They stated that board size may influence the level of voluntary disclosure. The level of disclosure is a strategic decision made of the board of directors. As a top-level management body, the board of directors formulates policies and strategies to be followed by managers. It has been argued that a greater number of directors on the board may reduce the likelihood of information asymmetry

With more directors, the collective experience and expertise of the board will increase, and therefore, the need for information disclosure will be higher.

### **3.2 Board composition:**

The board and its committees should have a balance of skills, experience, independence, and knowledge of the company. The board should be of sufficient size to operate effectively, but no so large as to be unwieldy. The board should

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have a balance of executive and non-executive directors so that no individual or small group is dominant.

Also Akhtaruddin noted that the executive directors of firm play a major role in making an appropriate composition of executive and non-executive directors, among board members. Board composition refers to the number of non-executive directors to the total number of directors.

An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with the independent exercise of their judgment. Grey directors are those who are not classified as independent.

Also(Chobpichien, 2008) divided directors into who were involved with routine administration that have an authority to approve activities of the company; (2) non-administrative directors who were independent and did not hold any position in the administration or did not work as employees of the companies. Reports of companies with higher proportions of independent non-executive directors on the board have higher level of voluntary disclosure. Also the presence of independent directors on the boards may improve the quality of financial statements.

This means the board of directors classified into one of three categories:

- A. Executive directors who are concerned with the administration.
- B. Non-executive directors such as independent non-executive directors who are not placed in any position and

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are not authorized to sign and are independent from the largest shareholders.

- C. Outside non-executive directors are those members who haven't any position in the company and were not representatives of the largest shareholders but they might be the representatives of customers, suppliers, or the creditors.

### **3.3 Board leadership structure:**

In role duality, Amar and Zeghal stated that a single individual serves as both the CEO and chairman of the board, creating a unified leadership structure. According to agency theory, the combined functions can impair board's monitoring. It also enables the CEO to engage in opportunistic behaviour because of his dominance over the board.

CEO duality may reduce a board's independence as well as its ability to effectively monitor managers including less disclosure of timely and relevant information to external stakeholders. This means there is a negative association between CEO duality and the level of voluntary disclosure in the annual report .

Also Baraka stated that the chair of the board of directors and CEO positions should be held by different persons (dual leadership structure). This means there is a negative relationship between disclosure quality and dominant personality.

### **3.4 Board independence and competence:**

(Clemente, and Labat, 2009) stated that the existence of an independent board of directors is a sign of good corporate governance and the independence can be maintained through appointments of outside directors. Outside directors are useful

tools for maintaining the independence of the board. Greater board independence lead to more transparency, better monitoring and increased voluntary disclosure.

Two crucial aspects of boards allow boards to be independent of management

A. The proportion of the board composed of independent nonexecutive directors

B. The presence on a nonexecutive chairman

The term board competence' refers to appropriate use of the directors' knowledge and experience. The experience and continuing education of the directors improves their ability, which may well be reflected in their voluntarily decision to adopt best practice in disclosure and thus leads to a greater degree of transparency. This means the voluntary disclosure increase when the competence of board members increases(Adawi and Rwegasira, 2011) .

### **3.5 Board meetings:**

Meetings are occasions for direct, face-to face communication and for the exchange of ideas and for the guidance of a company's affairs and for attending to any urgent matters that may arise.

This means the voluntary disclosure will increase as the frequency of the board meetings increases.

### **Other characteristics of BOD:-**

#### **A) Board nationality:**

Foreigners in the board, a large stock of qualified candidates would be available for the board (with broader industry experience). Also they have different backgrounds, foreign members can add valuable and diverse expertise which

domestic members do not possess. Foreign board members can also help assure foreign minority investors that the company is managed professionally in their best interests.

### **B)Board ethnicity:**

Homogeneous board is better in short-term, while heterogeneous board is better in long-term in terms of achieving corporate goals. Heterogeneous board results in emotional conflict that ultimately harmed firm performance. This means there is negative relationship between ethnic diversity and firm performance.

### **C)Board gender:**

Boards are traditionally composed of only male members. The presence of women on the board leads to gender diversity. Women are more likely to be more independent. The presence of women on the board could be perceived by shareholders that significant change is on the way, and making them more confident in the company's success, which results in increase in share price. Diversity in general is considered to improve organizational value and performance as it provides new insights and perspectives (Ujunwa, 2012).

### **E)Family controlled firms:**

It is stated that the level of information disclosure is likely to be less in family-controlled firms because the demand for information is less compared to firms that have wider ownership, Family control as a governance variable has a negative relation between family controlled firms and the level of voluntary disclosure, Family controlled firms have concentrated power and

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are very reserved in making voluntary disclosures (Akhtaruddin, et al, 2009).

The researcher sees that there is association between some board characteristics and voluntary disclosure level.

There is positive relationship between some of these characteristics such as (board size, board composition, board independence and competence, board meetings) and voluntary disclosure level. Also there is negative relationship between duality role of CEO and voluntary disclosure level.

The following are the reasons that lead the researcher to this opinion Board size may influence the level of voluntary disclosure as the ability of directors to control and promote value-creating activities is more likely to increase with the increase of directors on the board. With more directors, the collective experience and expertise of the board will increase, and therefore, the need for information disclosure will be higher. Board composition refers to the number of non-executive directors; large number of independent non-executive directors on corporate boards improves the comprehensiveness and quality of disclosure.

CEO duality affect voluntary disclosure as it reduce a board's independence and its ability to effectively monitor managers including less disclosure of timely and relevant information to external stakeholders.

### **Second: External auditor's characteristics and its effect on voluntary disclosure level:**

#### **External auditor definitions and Responsibilities :**

### **External auditor definitions:**

External auditors are qualified accountants who produce independent, professional reviews, making sure that information provides a 'true and fair' view of the organizations past financial performance and current financial position. Statutory audits are designed to provide confidence to shareholders and investors, giving all the vital information needed in a written statement to make an informed investment judgment.

External auditors can be defined also as are independent audit professionals who audit the financial statements of a company, legal entity or organization. They are expected to express an opinion on whether an entity's financial statements are free of material misstatements and are a true and fair representation of actual financial position.

External audit can be defined as : "The examination by an independent third party of the financial statements of an organization, resulting in the publication of an independent opinion whether or not, in all material respects, the financial report is presented fairly in accordance with Accounting Standards (Wang, et al, 2008).

### **b.External auditor responsibilities:**

External auditor has an important role to play in the regulatory framework, which require confidence in the audited financial information to ensure that the supervisory efforts had polices are effective, appropriate and based on accurate data. So it is required an open, co-operative and constructive between the supervisor and the auditor.

Also the study of (Marianne, 2007) stated that the primary aim of the audit is the verification of financial statements. The audit is an important part of the capital market framework as it not only reduces the cost of information exchange between managers and shareholders but also provides a mechanism to the markets that the information which management is providing is reliable.

The traditional role of the audit was mainly the detection and prevention of fraud.

External auditors have different responsibilities that can be summarized as:

- A. Planning assignments to make sure audit staff is fully aware of the client's business and relevant issues.
- B. Examining interim and end-of-year accounts.
- C. Collecting and reviewing financial accounts and other operational data.
- D. Challenging the effectiveness of current working practices, updating executive and non-executive managers on risks identified and recommending actions to be taken.
- E. Selecting samples of business areas and accounts for testing
- F. Conducting departmental reviews and interviewing key personnel about working practices.
- G. Identifying and recording material and significant errors, deficiencies or other variations from standard, reporting them to the audit supervisor (depending on the size of the organization, this may be done by the internal audit function).
- H. Assessing financial risk controls

- I. Ensuring value for money is delivered (again, this may be done by the organization's internal auditors).
- J. Preparing and submitting clear and concise audit reports.

Also (Marianne, 2007) presented the role of the external auditor in the supervisory process requires standards such as independence, objectivity and integrity to be achieved. Even though the regulator and external auditor perform similar functions, namely the verification of financial statements, they serve particular interests.

The responsibilities of the auditor summarized according to Marianne as:

**1- Auditors should plan and perform their audit procedures, evaluate and report on the results thereof, recognizing that non-compliance by the entity with law or regulations may materially affect the financial statements;** This can be done through:

- A. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and the industry and of the procedures followed in order to ensure compliance with that framework.
- B. Inspection of correspondence with relevant licensing or regulatory authorities.
- C. Making enquiries with directors as to whether they are aware of notice of any such possible instances of non-compliance with law and regulations.
- D. Obtaining written confirmation from the directors.

**2-Procedures to be followed when possible non-compliance with law or regulations is discovered.**

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Auditors should obtain an understanding of the nature of the act, the circumstances in which it occurred and sufficient other information to evaluate the possible effect on the financial statements when they become aware of information which indicates that non-compliance with law may exist.

### **3-Reporting non-compliance with law or regulations;**

Action taken by auditors to report actual non-compliance with law or regulations. Auditors should as soon as practicable, either: (a) communicate with management and the board of directors including the audit committee, or (b) obtain evidence that they are appropriately informed. Auditors can also: (a) Report to addressees of the auditor's report on the financial statements.

### **2- External auditor characteristics and its effect on voluntary disclosure:**

External auditor should have several characteristics that serve them to perform their responsibilities fairly and without fraud, the basic of these characteristics are independence, objectivity and integrity. Also these factors help them to provide high level of voluntary disclosure as there is positive association between independence, objectivity and integrity and voluntary disclosure level. More independence help to Identify and record material and significant errors, also provide more reliable financial statements of the company. These statements help users to make their investment decisions.

**Thus the researcher should present the importance of independence, objectivity and integrity to know how these**

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**characteristics' can enable external auditor to provide more voluntary disclosure:**

**Integrity**

It is required for external auditor to act for public Interest. This requires not only honesty but a wide range of Qualities such as fairness, candour, courage, intellectual honesty .

**Objectivity**

It is a state of mind which excludes bias, prejudice and Compromise and which gives fair and impartial Consideration to all matters that are relevant to the Present task .Objectivity requires the auditor's judgment not to be affected by conflicts of interests .The necessity for objectivity arises due to the fact that many important issues involved in the preparation of financial statements.

**Independence**

The need for independence arises because in many cases, users of financial statements and other third parties do not have sufficient information are, in fact, auditor independence is vital to public confidence in financial reporting.

(Wang, et al, 2008)stated that the role of external auditors is to conduct independent financial audits of financial reports of a client organization. Being independent means being a legal entity separate from the client organization. External auditors provide auditing as well as assurance services. The difference between assurance assignments and external audit assignments is that external audits are highly structured and highly regulated and assurance assignments are negotiated to the level of

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conformance that is required. This means members who conduct financial audits are required to be professionally qualified, professionally accredited, and experienced to conduct the audits. Also (Romanenko, 2011)the objectives of external auditor can be summarized as:-

- A. To identify and assess the risks of material misstatement of the financial statements due to fraud.
- B. To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud through designing and implementing appropriate responses .
- C. C)To respond appropriately to fraud or suspected fraud identified during the audit.

The researcher sees that the role of external auditors is to conduct independent financial audits of financial reports. This means members who conduct financial audits are required to be professionally qualified, professionally accredited, and experienced to conduct the audits, so there are some characteristics that should be provided for external audit such as independence, objectivity and integrity to know how these characteristics can enable external auditor to provide more voluntary disclosure.

### **Summery:**

The first part of this chapter talks about board of director as one of internal mechanisms, this part include several sections. The first section presents dimensions of board performance that can be summarized as the (contextual, educational, interpersonal, analytical, political, and strategic).

The second section presents the responsibilities of the board that can be summarized as the boards guide the strategic direction of the organization.

They encourage a sharing of information with management to encourage a decision making. The board of directors of the companies also is considered an important tool to protect shareholders' assets and to control the management of the company.

The third section presents the board of directors' characteristics and the effect of each of one these characteristics on voluntary disclosure level. These characteristics are (Board size, Board composition, Board leadership structure, Board independence and competence, Board meetings). There is other characteristics of the board which are (board nationality, ethnicity, gender, and family controlled firms).

The fourth section shows the effect of external auditor on voluntary disclosure. This section defines external auditor as independent audit professionals who audit the financial statements of a company, and express an opinion on whether an entity's financial statements are free of material misstatements and are a true and fair representation of actual financial position. Also it provides external auditor responsibilities and their characteristics which include (integrity, objectivity, and independence) and the effect of these characteristics on voluntary disclosure.

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