

1 Critical Factors Influencing Voluntary Disclosure: The Palestine 2 Exchange "PEX"

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6

7 **Abstract**

8 This study research examines which factors influence voluntary disclosure in the annual
9 reports. Since corporate scandals have become a known feature in recent years, voluntary
10 disclosure should be increased, and be documented clearly in the annual reports. The study
11 analyse 48 listed companies at the Palestine Exchange ?PEX? for the year 2011, and 35
12 companies for the year 2007 which represented the whole population for that period. The
13 study also examines the extent to which critical factors such as nonexecutive directors, audit
14 committee, board size, board activity, and number of shareholders influence voluntary
15 disclosure practices. The analysis show that the following critical factors influence voluntary
16 disclosure; non-executive directors, board size, audit committee, and number of shareholders.
17 The factor do not influence the company's voluntary disclose information is board activity.

18

19 **Index terms**— voluntary disclosure; non-executive directors; audit committee; shareholders; board size;
20 board activity.

21 **1 Introduction**

22 financial disclosure can be classified into two parts: mandatory and voluntary (nonmandatory) disclosures.
23 Corporate voluntary disclosure, which is optional and additional to requirements, provides free choice on the part
24 of managers to provide information to the annual reports users. (Nasir, 2004). Understanding why companies
25 voluntarily disclose information is useful for both producers and users of accounting information, as well as
26 for accounting policy. ??Buzbee, 1975; ??eek et al. 1995). Disclosure provides important information to the
27 shareholders, so the disclosure act as a link between management and shareholders. The shareholders is the
28 most important stakeholders, but not only once, so many parties other than shareholders receive benefits from
29 financial disclosure, like creditors, employees, government, suppliers, ? etc whose called stakeholders. (Fang
30 and Jin 2012). Voluntary disclosure strengthens this bridge and builds the trust between the corporations and
31 stakeholders by involving them with corporations' life. What management of corporations must do in order
32 to get their shareholders' confidence and trust. The question arises here which factors that make corporations
33 disclose more information in their annual reports? World corporations are faced with a changing, challenging
34 landscape which sees a series of financial statement frauds and shocking corporate scandals in US and Europe
35 such as WorldCom, Enron, etc. As well as the recent financial crisis that negatively affects the world economies.
36 These frauds and scandals constitute a major reason due to the lack of stakeholders' trust on the corporations.
37 Information asymmetry and agency conflicts which exist between the management and the stakeholder also play
38 a major role in creating these frauds and scandals. The core question here; what corporations are going to do
39 in order to gain their stakeholders' trust? As we notice from previous discussion, corporate disclosure has been
40 cited as being the link of trust between a corporation's management, stockholders and other users of financial
41 reports.

42 In light of recent corporate scandals such as USA Building, Enron, and WorldCom ??Heidi and Marlene,
43 2003) restoring of public confidence or trust becomes the main agenda in today's business leaders. Disclosing

3 II.

44 more information on the company's capital structure and control can be an important way to achieve that goal
45 (Rogers, 2006). Beasley (1996) and Beasley et, al. (2000) emphasise the crucial role of full disclosure in avoiding
46 financial reporting fraud. Investigating a series of financial statement frauds that have occurred in recent years,
47 Guan, et, al. (2007) find that to protect investors' rights and enhance information transparency, the regulatory
48 authorities of securities markets and information intermediaries have exerted great effort to advocate corporate
49 governance, thus lessening the occurrence of adverse selection and agency problems as a result of the information
50 asymmetry.

51 The study investigates the Palestinian Exchange, due to the complicated political situation in Palestine (West
52 Bank and Gaza Strip), which make Palestinian economy dependant on Israel economy. The Palestine Exchange
53 (PEX) was established in 1995 to promote investment in Palestine, which is considered as a rising market, and
54 lack for applied research.

55 2 Inform

56 Canada, China, Sweden and Australia (Anderson, 2005;Huafang & Jianguo, 2007) as well as in developing
57 countries such as Malaysia (Hossain et al., 1994 ; ??aniffa and Cook, 2002;Nasir, 2004.), Zimbabwe, (Musa
58 Mangena 2007.), Saudi Arabia (Khalid 2006.) and Kenya ?etc. , These researches have focused on examining
59 different corporate governance characteristics such as board of directors, managerial ownership, audit committee
60 and other variables, their effect on voluntary information disclosure in annual financial reports. ??aniffa and
61 Cook (2002) for instance examine the relationship between a number of corporate governance characteristics,
62 cultural and firmspecific characteristics and the extent of voluntary disclosure in the annual reports of Malaysian
63 companies. Nasir (2004) examines the influence of firm's financial status in explaining the level of voluntary
64 disclosure among financial distressed firms in Malaysia. investigate the extent to which corporate governance
65 attributes, ownership structure and company characteristics influence voluntary disclosure practices among
66 Kenyan companies. Swedish companies have also been studied by (Anderson, 2005). So that he depends on
67 the agency theory to find out which factors that influence these corporations to disclose voluntary disclosure
68 information in the annual reports. And so on many researches have been done among different developed and
69 developing countries to figure out which factors could contribute to more disclosures by companies in their
70 financial annual reports.

71 Due to the fact that no previous studies were keen to examine the impact of critical factors influenced voluntary
72 disclosure among listed Palestinian companies, and the special complicated political situation in Palestine, this
73 research is considered important for this region. It is based on previous studies on voluntary disclosure were
74 conducted by developing and developed countries. Researchers try to examine to what extent voluntary disclosure
75 can be influenced by certain critical factors (such as non-executive directors, audit committee, board size, and
76 board activity, number of shareholders). Among listed Palestinian companies.

77 In examining the relationship between critical factors and voluntary disclosure, this research attempts to answer
78 if these factors are influencing voluntary disclosure in the Palestinian's annual report or not. The main critical
79 factors are board size, board activity, audit committee, non-exclusive directors, and number of shareholders;
80 affect the extent of voluntary disclosure in annual reports. The investigation on voluntary disclosure provides
81 an excellent opportunity to apply agency theory. Managers who are directly involved in the day-today running
82 of their firms are in the position to directly communicate corporate information through the annual reports to
83 shareholders (owners) and other external stakeholders. The disclosure of information helps to reduce the costs
84 of agency relationship when there is an information asymmetry between them and the shareholders.

85 3 II.

86 Theory and Hypothesis Developing a) Voluntary Information Disclosure Voluntary disclosure is measured by
87 the amount and detail of non-mandatory accounting and nonaccounting information that is contained in the
88 management discussion and analysis in the annual report. (Haniffa and Cooke, 2002) have defined voluntary
89 disclosure by disclosing non-mandatory accounting and non-accounting information. b) Incentives for Voluntary
90 Disclosure Healy and Palepu (1993) provide a comprehensive review of voluntary disclosure literature; they note
91 that research into voluntary disclosure decisions tends to focus on the informational role of reporting for capital
92 market participants. They identify five forces that have been found to be related to managers' decisions to
93 voluntarily disclose information for capital market reasons:

94 The Capital Market Transactions Hypothesis: Firms have incentives to make voluntary disclosures in order to
95 reduce information asymmetry and therefore reduce the cost of external financing through reduced information
96 risk.

97 The Corporate Control Contest Hypothesis: When corporate performance is poor, managers use voluntary
98 disclosures in an attempt to increase firm valuation and to explain the poor performance, therefore reducing the
99 risk of management job losses.

100 The Stock Compensation Hypothesis: Managers who are rewarded with stock compensation have an incentive
101 to use voluntary disclosures to reduce the likelihood of insider trading allegations, and firms have incentives to
102 increase disclosures to reduce contracting costs with managers who receive stock compensation.

103 The Litigation Cost Hypothesis: Managers have an incentive to disclose bad news to avoid legal actions for
104 inadequate disclosure, but have an incentive to decrease disclosures of forecasts that might prove to be inaccurate.
105 The Proprietary Costs Hypothesis: Voluntary disclosures will be constrained if managers perceive that
106 disclosure could be competitively harmful.

107 **4 i. Non-Executive Directors**

108 Non-executive directors act as a reliable mechanism to diffuse agency conflicts between managers and owners
109 (Fama & Jensen 1983). They are viewed as providing the necessary checks and balances. The importance of
110 non-executive directors has also been demonstrated in other settings; positive share price reactions to specific
111 critical events when the firm's board is dominated by outside (non-executive) directors have been documented.
112 Examples of these events include tender offer bids (Byrd & Hickman, 1992; Cotter et al. 1997), the adoption of
113 poison pills (Brickley et al. 1994), and management buyout announcements (Lee et al. 1992). These empirical
114 research findings verify the relevance of non-executive directors as a governance mechanism that enhances the
115 board's capacity to ameliorate agency conflict between owners and managers, D. G. Barako, P. Hancock and
116 H.Y.
117 Izan/FRRaG (Financial Reporting, Regulation and Governance) 2006, 5:1 6 which may occur in the decision
118 to voluntarily disclose information in the annual reports. Based on these earlier findings the following hypothesis
119 is stated: H1: The extent of non-executive directors is positively associated with the level of voluntary disclosure.

120 **5 ii. Audit Committee**

121 Prior research studies provide evidence of a positive association between the presence of an audit committee
122 and corporate disclosure practices (e.g. Ho & Wong, 2001). For example, McMullen (1996) reported that the
123 presence of an audit committee is associated with reliable financial reporting, such as, reduced incidence of
124 errors, irregularities, and other indicators of unreliable reporting. In addition, Bradbury (1990 p.21) argued
125 that: "audit committees are commonly viewed as monitoring mechanisms that enhance the audit attestation
126 function of external financial reporting". The board usually delegates responsibility for the oversight of financial
127 reporting to the audit committee to enhance the breadth of relevance and reliability of the annual report (DeZoort,
128 1998; Wolnizer, 1995). Thus, audit committees can be a monitoring mechanism that improves the quality of
129 information flow between firm owners (shareholders and potential shareholders) and managers, especially in the
130 financial reporting environment where the two have disparate information levels. Given the influence of audit
131 committees on the context and content of corporate annual reports, the following hypothesis is tested: D. G.
132 Sarako According to Sarbanes-Oxley act requires that all members of the audit committee be independent, and
133 company must include at least one member who is a financial expert. As well as the recent studied Samaha and
134 Dahawy (2010 and 2011) found an audit committee existence complementary effect on the general corporate
135 voluntary disclosures. Thus we generate our second hypothesis: H2: There is a positive association between the
136 existences of an audit Committee and the levels of voluntary disclosure in the annual reports.

137 iii. Board Size Jensen (1993) and Yermack (1996) argue that board of directors are less effective monitors as
138 they grow in size, since the control over management will be reduced. Moreover, a smaller board of directors will
139 more likely take responsibility for monitoring a corporation's operations than a larger board of directors, according
140 to Vaefas (2000). Larger board of directors may be slower to react to decisions that require an immediate course
141 of action. Furthermore, as more directors are added, the board of directors loses the ability to be direct and
142 decisive in their operation; therefore, it will be easier for the CEO to control the board of directors. The directors
143 also become less candid in the ability to be critical of one another, which results in less efficient decision making
144 (Jensen, 1993).

145 Ezat and El-Masry (2008) find that board size is positively associated with levels of corporate voluntary
146 disclosure. Based on these arguments our third hypothesis is as follows: H3: There is a negative association
147 between board size and the levels of voluntary disclosures in the annual reports.

148 **6 iv. Number of Shareholders**

149 The greater the number of shareholders, the more likely it is that their information needs will be different, which
150 results in a greater need for different information to be disclosed ??Cooke, 1989a). On the other hand Samaha
151 and Dahawy (2010 and 2011) did not find any evidence for an association between number of shareholders and
152 the corporate voluntary disclosure level. Our fourth hypothesis is therefore as follows:

153 H4: There is a positive association between number of shareholders and the levels of voluntary disclosures
154 in the annual reports. v. Board Activity Anderson (2005) states that the board of directors will be motivated
155 to carry out its role as monitors of the management, as the directors' compensation gets higher. Therefore,
156 corporations can be expected to have more disclosure since it will be more effective in monitoring managerial
157 opportunism. Ezat and El-Masry (2008) and Samaha and Dahawy (2010 and 2011) found that the association
158 between board independence and voluntary disclosure in Egypt is positive. Our last hypothesis is therefore as
159 follows:

160 **7 vi. Statistical Differences**

161 The following hypothesis is stated to discover if there any significant differences between the levels of voluntary
162 disclosure related to variable of financial year 2007, 2011. Throughout 2007, "PEX" work went on in order
163 to develop the, electronic systems, and work procedures. These developments included preparing automated
164 programs that enable the "Center" to execute its operations rapidly and accurately, and prepare statistical
165 reports efficiently. As Company guide (2007), The Palestine Securities Exchange launched the e-trading service
166 in April 2007. We stated the following hypothesis:

167 H6: There is a significant difference at the level of voluntary disclosure related to variable of financial year
168 ??2007, ??011).

169 **8 III.**

170 **9 Methodology a) Research Population and Sample**

171 Due to the relatively small number of companies listed on the Palestinian Securities Exchange all companies listed
172 in 2011 were considered for inclusion in the survey which is called consensus survey. The total numbers of all
173 companies listed in 2011 are 48 .The annual reports prepared at 31-12-2011 of these companies were considered.

174 **10 b) Dependent Variable (Voluntary Disclosure)**

175 The voluntary disclosure checklist was prepared to measure voluntary disclosure, based on the checklist developed
176 by ??eek et al. (1995) in relation to the voluntary disclosures of U.K., U.S. and Continental European firms.
177 Data for the dependent variable (voluntary disclosure) is measured by an index of disclosure. Before determining
178 the index of each company in the sample, a scoring sheet is prepared based on the selection of voluntary items
179 information. Voluntary disclosure is disclosing non-mandatory accounting and non accounting information in the
180 financial annual reports (Haniffa and Cooke, 2002). In this research, the annual reports, website information and
181 disclosure requirements issued by Palestinian Securities Exchange in order to examine the research object only
182 the most recent annual report and website information disclosure activities are used.

183 A disclosure checklist was compiled based on an analysis of international trends and observations of standard
184 reporting practices, taking into account relevant research studies and comprehensive surveys such as Gray,
185 Campbell and Shaw ??1984] and Tonkin [1989]. The checklist began with a list of 128 items of information that
186 were potentially voluntary. These items were then compared to the respective Palestinian securities exchange
187 market disclosure requirements faced by the companies in the sample. Even though, it obviously eliminates
188 some voluntary disclosures for some companies. The final checklist consists of seventy nine items of information.
189 Thus, we use a common set of seventy-nine voluntary disclosure items for the sample selected. This enables us
190 to compare voluntary disclosures across companies. In order to carry out the study, the 2007 annual reports
191 were obtained for the samples of companies. At the time of data collection, these were the latest annual reports
192 available. The contents of each annual report were compared to the items on the checklist and coded as 1 or 0
193 (or not applicable), depending upon whether the annual report contained or did not contain (respectively) the
194 disclosure item. For each company, a voluntary disclosure index was then calculated as the ratio of the actual
195 score awarded to the company divided by the maximum potential score applicable to that company. In other
196 words, the applicability of the item concerned was also taken into account: companies were not penalized if
197 a disclosure item was not relevant. In order to assess this aspect, the entire annual report was studied and a
198 judgment was made on the matter. Thus, the dependent variable is the voluntary disclosure index.

199 The voluntary disclosure score for each company is additive and unweight. Unweight scores have been used in
200 other empirical studies (e.g., Cooke 1989).

201 The voluntary disclosure items are categorized into three major types of information: strategic, nonfinancial,
202 and financial. One reason for doing this is that the decision relevance of information probably varies by type.
203 For example, the strategic and financial information categories have obvious decision relevance for investors. The
204 non-financial information category is directed more toward a company's social accountability, extending beyond
205 the investor group to include other company stakeholders as well. As a result, the variables affecting voluntary
206 disclosure choices may also vary by information type.

207 The disclosure index for each company is calculated as follows.

208 Where: I_j Disclosure Index N_j Number of items expected for j th firm, n_j X_{ij} 1 if the item is disclosed, 0
209 otherwise so that $0 \leq I_j \leq N_j$ c_j Independent Variable (Critical Factors) This section described how the independent
210 variables will be measured: IV.

211 **11 Empirical Results**

212 **12 a) Multicollinearity**

213 Before running the multiple regressions, the independent variables have to be examined and checked to see if there
214 is correlation between them. Correlation between the independent variables is not a problem until it exceeds the
215 limit of 0.8 Thomas (1996). Table 1, indicate that the correlation between the independent variables is quite

216 low. The regression analysis results indicated that the independent variables explained 49.1% of the variance in
217 behaviour intention.

218 It was also noticed that the non-executive directors had the impact on voluntary disclosure $\beta=0.197$, $p < 0.01$. Based on these findings and in the presence of a significant relationship between nonexecutive directors
219 and voluntary disclosure was accepted, hypothesis 1 is supported.

220 221 It was also noticed that the Audit committee had the strongest impact on voluntary disclosure $\beta=0.383$, $p < 0.01$. Based on these findings and in the presence of a significant relationship between Audit committee and
222 voluntary disclosure was accepted, hypothesis 2 is supported.

223 224 It was also noticed that the Board size had the impact on voluntary disclosure $\beta=0.167$, $p < 0.01$. Based on these findings and in the presence of a significant relationship between Board size and voluntary disclosure
225 was accepted, hypothesis 3 is supported. It was also noticed that the Number of shareholders had the impact
226 on voluntary disclosure $\beta=0.221$, $p < 0.01$. Based on these findings and in the presence of a significant
227 relationship between Number of shareholders and voluntary disclosure was accepted, hypothesis 4 is supported.

228 229 It was also noticed that the Board Activity had no impact on voluntary disclosure $\beta=0.182$, $p > 0.05$. Based on these findings and in the presence of no significant relationship between Board Activity and voluntary
230 disclosure was not accepted, hypothesis 5 is rejected. c) Statistical Differences Also the analysis used T. test to
231 examine the difference between the levels of voluntary disclosure related to variable of financial year 2007, 2011.
232 As it appears in difference table 3 , the result indicates that there is a significant difference between the two of
233 financial year 2007 and 2011, since the mean for 2011= 0.417 and for 2007= 0.308 at a confidence level =0.05 and
234 $p=0.000$. The analysis support the hypothesis 6 and we found there are differences because of that we accepted
235 the hypothesis.

237 **13 Conclusion**

238 This study finds out whether the critical factors stated by researchers influencing the voluntary disclosure and
239 also the researchers try to examine the changes of voluntary disclosure through the time pass. Our study findings
240 that selected critical factors, nonexecutive directors, audit committee, numbers of shareholders, and board size,
241 are positively influencing the voluntary disclosure Which is agreed with Ezat and Al-Masry (2008), and apposite
242 to Jensen (1993), Yermack (1996), and Vaefas (2000), which they stated that there is negative correlation between
243 board size and voluntary disclosure. Also we found that board of activities has no influence on voluntary disclosure
244 which it apposite to Anderson (2005) , Ezat and El-Masry (2008), and ??ahawy (2010 and2011) . It also found
245 that the voluntary disclosure slightly improved when we compared 2007 with 2011.

246 Finally we can say that the stated critical factors have a positive influencing effect on voluntary disclosure
247 but still the level of voluntary disclosure is low. Also the selecting critical factors used by researchers not only
248 the ones there are so many other factors can be used such as Cultural aspect is an important factor that could
249 influence voluntary disclosure. This was examined by others, but the researchers encourage experts to carry
250 further investigations on this factor. ¹

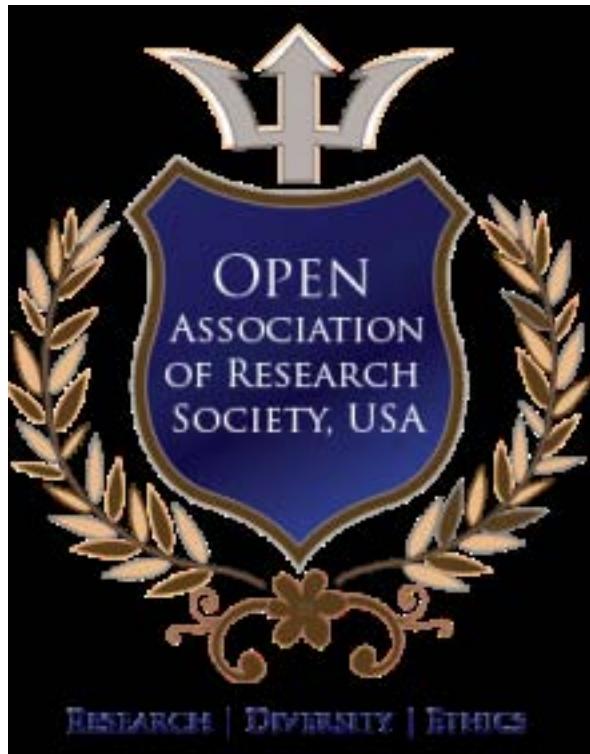


Figure 1:

Figure 2:

1

Figure 3: Table 1 :

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Figure 4: Table 2 :

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Figure 5: Table 3 :

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13 CONCLUSION

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