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# Critical Factors Influencing Voluntary Disclosure: The Palestine Exchange "PEX"

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

*Keywords :* *voluntary disclosure; non-executive directors; audit committee; shareholders; board size; board activity.*

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# Critical Factors Influencing Voluntary Disclosure: The Palestine Exchange "PEX"

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

*Keywords : voluntary disclosure; non-executive directors; audit committee; shareholders; board size; board activity.*

## I. Introduction

Financial disclosure can be classified into two parts: mandatory and voluntary (nonmandatory) disclosures. Corporate voluntary disclosure, which is optional and additional to requirements, provides free choice on the part of managers to provide information to the annual reports users. (Nasir, 2004). Understanding why companies voluntarily disclose information is useful for both producers and users of accounting information, as well as for accounting policy. (Buzbee, 1975; Meek et al. 1995). Disclosure provides important information to the shareholders, so the disclosure act as a link between management and shareholders. The shareholders is the most important stakeholders, but not only once, so many parties other than shareholders receive benefits from financial disclosure, like creditors, employees, government, suppliers, … etc whose called stakeholders. (Fang and Jin 2012). Voluntary disclosure strengthens this bridge and builds the trust between the corporations and stakeholders by involving them with corporations' life. What management of corporations must do in order to get their shareholders' confidence and trust. The question arises here which factors that make corporations disclose more information in their annual reports?

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World corporations are faced with a changing, challenging landscape which sees a series of financial statement frauds and shocking corporate scandals in US and Europe such as WorldCom, Enron, etc. As well as the recent financial crisis that negatively affects the world economies. These frauds and scandals constitute a major reason due to the lack of stakeholders' trust on the corporations. Information asymmetry and agency conflicts which exist between the management and the stakeholder also play a major role in creating these frauds and scandals. The core question here; what corporations are going to do in order to gain their stakeholders' trust? As we notice from previous discussion, corporate disclosure has been cited as being the link of trust between a corporation's management, stockholders and other users of financial reports.

In light of recent corporate scandals such as USA Building, Enron, and WorldCom (Heidi and Marlene, 2003) restoring of public confidence or trust becomes the main agenda in today's business leaders. Disclosing more information on the company's capital structure and control can be an important way to achieve that goal (Rogers, 2006).

Beasley (1996) and Beasley et, al. (2000) emphasise the crucial role of full disclosure in avoiding financial reporting fraud. Investigating a series of financial statement frauds that have occurred in recent years, Guan, et, al. (2007) find that to protect investors' rights and enhance information transparency, the regulatory authorities of securities markets and information intermediaries have exerted great effort to advocate corporate governance, thus lessening the occurrence of adverse selection and agency problems as a result of the information asymmetry.

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

### *a) Litreture Review*

Many studies have examined the critical factors influencing voluntary disclosure among listed corporations in both developed countries such as US, UK,



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

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

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

## II. Theory and Hypothesis Develping

### *a) Voluntary Information Disclosure*

Voluntary disclosure is measured by the amount and detail of non-mandatory accounting and non-accounting information that is contained in the management discussion and analysis in the annual report. (Haniffa and Cooke, 2002) have defined voluntary disclosure by disclosing non-mandatory accounting and non-accounting information.

### *b) Incentives for Voluntary Disclosure*

Healy and Palepu (1993) provide a comprehensive review of voluntary disclosure literature; they note that research into voluntary disclosure decisions tends to focus on the informational 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: Firms 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.

#### i. *Non-Executive Directors*

Non-executive directors act as a reliable mechanism to diffuse agency conflicts between managers and owners (Fama & Jensen 1983). They are viewed as providing the necessary checks and balances

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needed to enhance board effectiveness (Franks et al. 2001). Chen & Jaggi (2000) and Haniffa & Cooke (2002), provide empirical evidence of the relationship between the proportion of non-executive directors on the board and corporate disclosure.

The importance of non-executive directors has also been demonstrated in other settings; positive share price reactions to specific critical events when the firm's board is dominated by outside (non-executive) directors have been documented. Examples of these events include tender offer bids (Byrd & Hickman, 1992; Cotter et al. 1997), the adoption of poison pills (Brickley et al. 1994), and management buyout announcements (Lee et al. 1992). These empirical research findings verify the relevance of non-executive directors as a governance mechanism that enhances the board's capacity to ameliorate agency conflict between owners and managers, D. G. Barako, P. Hancock and H.Y.

Izan/FRRaG (Financial Reporting, Regulation and Governance) 2006, 5:1 6 which may occur in the decision to voluntarily disclose information in the annual reports. Based on these earlier findings the following hypothesis is stated:

H1: The extent of non-executive directors is positively associated with the level of voluntary disclosure.

ii. *Audit Committee*

Prior research studies provide evidence of a positive association between the presence of an audit committee and corporate disclosure practices (e.g. Ho & Wong, 2001). For example, McMullen (1996) reported that the presence of an audit committee is associated with reliable financial reporting, such as, reduced incidence of errors, irregularities, and other indicators of unreliable reporting. In addition, Bradbury (1990 p.21) argued that: "audit committees are commonly viewed as monitoring mechanisms that enhance the audit attestation function of external financial reporting". The board usually delegates responsibility for the oversight of financial reporting to the audit committee to enhance the breadth of relevance and reliability of the annual report (DeZoort, 1998; Wolnizer, 1995). Thus, audit committees can be a monitoring mechanism that improves the quality of information flow between firm owners (shareholders and potential shareholders) and managers, especially in the financial reporting environment where the two have disparate information levels. Given the influence of audit committees on the context and content of corporate annual reports, the following hypothesis is tested: D. G. Barako, P. Hancock and H.Y. Izan/FRRaG (Financial Reporting, Regulation and Governance) 2006, 5:1 7

According to Sarbanes-Oxley act requires that all members of the audit committee be independent, and company must include at least one member who is a financial expert.As well as the recent studied Samaha and Dahawy (2010 and 2011) found an audit committee existence complementary effect on the general corporate voluntary disclosures. Thus we generate our second hypothesis:

H2: There is a positive association between the existences of an audit Committee and the levels of voluntary disclosure in the annual reports.

iii. *Board Size*

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

Ezat and El-Masry (2008) find that board size is positively associated with levels of corporate voluntary disclosure. Based on these arguments our third hypothesis is as follows:

H3: There is a negative association between board size and the levels of voluntary disclosures in the annual reports.

iv. *Number of Shareholders*

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

H4: There is a positive association between number of shareholders and the levels of voluntary disclosures in the annual reports.

v. *Board Activity*

Anderson (2005) states that the board of directors will be motivated to carry out its role as monitors of the management, as the directors' compensation gets higher. Therefore, corporations can be expected to have more disclosure since it will be more effective in monitoring managerial opportunism. Ezat and El-Masry (2008) and Samaha and Dahawy (2010 and 2011) found that the association between board independence and voluntary disclosure in Egypt is positive. Our last hypothesis is therefore as follows:



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H5: There is a positive association between board Activity and the levels of voluntary disclosures in the annual reports.

vi. *Statistical Differences*

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

H6: There is a significant difference at the level of voluntary disclosure related to variable of financial year (2007, 2011).

## III. Methodology

*a) Research Population and Sample*

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

*b) Dependent Variable (Voluntary Disclosure)*

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

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

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

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

The disclosure index for each company is calculated as follows.

$$I_j = \frac{\sum_{t=1}^{n_j} X_{ij}}{n_j}$$

Where:

I j Disclosure Index

N j Number if items expected for jth firm, nj ≤ 79

Xij 1 if the item is disclosed, 0 otherwise so that 0≤ Ij≤1

t Year

*c) Independent Variable (Critical Factors)*

This section described how the independent variables will be measured:

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- Non-executive directors: proportion of independent non-executive directors to total directors.
- Audit committee: coded '1' to indicate existence of audit committee and '0' to indicate nonexistence.
- Board size: board of director's size, measured by counting the total number of the directors for each company.
- Number of shareholders: number of shareholders, measured by counting the total number of the shareholders for each company. (natural log).
- Board activities: Board activities measured by board compensation which is equal the log of the total amount of compensation given to the board of director for each company.

## IV. Empirical Results

*a) Multicollinearity*

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

*Table 1 :* The correlation between independent variables

| Variables | Non-ex. | Audit co. | Board size | Number sh. | Board act. |
|---|---|---|---|---|---|
| Non-ex | 1 | | | | |
| Audit co. | 0.147 | 1 | | | |
| Board size | 0.182 | 0.032 | 1 | | |
| Number sh. | 0.23 | 0.121 | 0.327 | 1 | |
| Board act. | 0.158 | 0.721 | 0.165 | -0.016 | 1 |

*b) Multiple Regressions*

Statistical packages were used for the Social Sciences (SPSS) in order to test the hypotheses. The multiple regressions are used. Five hypotheses were developed to explain the relationship between independent variables (critical factors) and voluntary disclosure. Multiple regression analysis was used to test the validity of these hypotheses. Analysis table shows the results of these tests.

*Table 2 :* The Regression result

| | critical factors | Beta | T | p-value |
|---|---|---|---|---|
| H1 | Non-executive directors | 0.197 | 5.522 | 0.000** |
| H2 | Audit committee | 0.383 | 10.727 | 0.000** |
| H3 | Board size | 0.167 | 4.001 | 0.000** |
| H4 | Number of shareholders | 0.221 | 8.011 | 0.000** |
| H5 | Board Activity | 0.182 | 1.337 | 0.192 |
| | | | | |
| | R2 | 0.491 | | |

The non-executive directors, audit committee, board size, number of shareholders and board activity, were entered into the regression to test their impact on voluntary disclosure as dependent variables. The results are shown in table 2:

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

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 non-executive directors and voluntary disclosure was accepted, hypothesis 1 is supported.

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 voluntary disclosure was accepted, hypothesis 2 is supported.

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 was accepted, hypothesis 3 is supported.



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It was also noticed that the Number of shareholders had the impact on voluntary disclosure beta=0.221, $p < 0.01$. Based on these findings and in the presence of a significant relationship between Number of shareholders and voluntary disclosure was accepted, hypothesis 4 is supported.

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 disclosure was not accepted, hypothesis 5 is rejected.

*c) Statistical Differences*

Also the analysis used T. test to examine the difference between the levels of voluntary disclosure related to variable of financial year 2007, 2011. As it appears in difference table 3 , the result indicates that there is a significant difference between the two of financial year 2007 and 2011, since the mean for 2011= 0.417 and for 2007= 0.308 at a confidence level **α** =0.05 and p=000. The analysis support the hypothesis 6 and we found there are differences because of that we accepted the hypothesis.

*Table 3 :* Differences between the levels of voluntary disclosure

| YAEARE | N | MEAN | STD | D.F | T.TEST | SIG |
|---|---|---|---|---|---|---|
| 2011 | 48 | 0.417 | 0.097 | 81 | 3.989 | .000 |
| 2007 | 35 | 0.308 | 0.121 | | | |

## V. Conclusion

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

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

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