FIRMS' CHARACTERISTICS AFFECTING THE LEVEL OF VOLUNTARY DISCLOSURE OF INDONESIAN COMPANIES LISTED ON THE JAKARTA STOCK EXCHANGE

by:

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CIRI FIRMA KHUSUS YANG MEMPENGARUHI TINGKAT AMALAN PENZAHIRAN SUKARELA SYARIKAT INDONESIA YANG TERSENARAI DI BURSA SAHAM JAKARTA

ABSTRAK

Kajian ini bertujuan untuk mengenalpasti tujuh ciri firma khusus yang mempengaruhi tingkat amalan penzahiran sukarela syarikat Indonesia. Butiran penzahiran sukarela telah dikenal pasti melalui maklumat yang dizahirkan di laporan tahunan dan merujuk kepada butiran penzahiran sukarela yang dikenalpasti daripada kajian sebelum ini. Butiran penzahiran sukarela dibandingkan dengan Piawaian Perakaunan Indonesia dan Peraturan Agensi Pasaran Modal Pelaksanaan (BAPEPAM). Perbincangan dengan beberapa pihak profesional telah dijalankan dan selepas ini senarai terakhir butiran penzahiran sukarela disediakan. Sebagai asas penentuan tingkat penzahiran sukarela setiap syarikat, satu kajian telah dijalankan untuk menentukan markah wajaran kepentingan setiap butiran penzahiran sukarela daripada kacamata kedua-dua pengguna dan penyedia laporan tahunan. Purata wajaran kepentingan setiap butiran telah ditentukan berasaskan jawapan daripada 78 pengguna institut (iaitu broker saham, pengurus pelaburan, dan penanggung) dan jawapan daripada 58 penyedia laporan tahunan (pengarah kewangan) syarikat yang telah disenaraikan di Bursa Saham Jakarta. Berasaskan dapatan kajian berhubung dengan kepentingan butiran penzahiran secara sukarela, didapati 19 butiran boleh dicadangkan kepada badan pengawalan Indonesia sebagai mandatori kerana kesemua butiran ini telah dianggap penting oleh kedua-dua pengguna dan penyedia penyata kewangan.

Kajian ini juga mendapati empat faktor (iaitu: komposisi pengarah, ukuran firma, operasi firma, dan jenis industri) didapati mempunyai perhubungan yang signifikan dengan tingkat penzahiran sukarela. Sementara jawatan kuasa audit, umpilan (*leverage*), dan keuntungan didapati tidak signifikan. Kajian ini juga mendapati sebab utama syarikat menzahirkan item secara sukarela dalam laporan tahunan adalah untuk menerangkan secara terperinci keadaan prestasi syarikat, menarik minat pelabur baru, dan menambahkan modal syarikat di pasaran.

ABSTRACT

This study has sought to investigate firms' characteristics affecting the level of voluntary disclosure of Indonesian companies listed on the Jakarta Stock Exchange. Voluntary disclosure items were determined by observing information presented in annual reports and by referring to a large number of voluntary items found by previous researchers in other countries. These voluntary items were then compared with the Indonesian Accounting Standard and the Capital Market Executive Agency's (BAPEPAM) regulations. A discussion with some professional parties was conducted after which a final list of voluntary items was derived. As a basis for scoring the level of voluntary disclosure of each company, a survey was conducted to determine the importance of each voluntary item as perceived both by users and preparers of annual reports. Based on responses from 78 institutional users (i.e. stockbrokers, investment managers, and underwriters) who are listed as members of the Jakarta Stock Exchange and 58 preparers (financial directors of public-listed companies), a list of weighted score of importance of each item was determined. There are nineteen voluntary items that can be recommended to the Indonesian regulatory bodies to be made as mandatory since these items were highly ranked in importance by both users and preparers. It was also found that there are four firms' characteristics (i.e. the board of directors' composition, firm size, firm operation, and industry types) that have a significant influence on the level of voluntary disclosure. Audit committee, leverage, and profitability were not found to be significant. This study also found that the main reason companies disclose voluntary items is to describe detailed condition or performance of the company so as to attract new shareholders, and to raise capital from the market.

CHAPTER I

INTRODUCTION

1.1 Introduction

This chapter introduces the research agenda of this study. The chapter presents the background of the study, problem statement, focus of the study, research questions, research objectives, significance of the study, and organization of the remaining chapters.

1.2 Background of The Study

One of the major objectives of financial statement is to supply information for both internal and external users for making financial decisions (FASB, 1978). This requires a proper disclosure of financial data and other relevant information. The term disclosure was defined by Hendriksen and Breda (1992) as the presentation of information necessary for the optimum operation of efficient capital market. Penmann (1988) stated that financial disclosure could be divided as (a) mandatory disclosure, and (b) voluntary disclosure. Mandatory disclosure is defined as any financial item disclosed in the annual reports of companies that is prescribed by the Accounting Standards and/or the Stock Exchange Regulations. Voluntary disclosure is defined as any financial item or data disclosed in annual reports of companies that is not prescribed by the Companies Act and/or Accounting Standards, and, in addition, for public-listed companies, the Stock Exchange Regulations.

Mandatory disclosures are in the nature of historical information (Penmann, 1988) and describe only information prescribed by accounting standards and/or the Stock Exchange Regulations. It would not have included other useful information that is

needed by users, such as earning forecast, capital expenditure, occupational background of directors, or description of marketing networks. Since interested parties or users would be likely to include such information in their decision-making, this is usually available through voluntary disclosure.

The study on disclosure in annual reports cannot be separated from agency theory. Agency theory is generally concerned with principal-agent relationship (Fama & Jensen, 1983; and Jensen & Meckling, 1976). In such a relationship, one party (the principal) hires another party (the agent) to perform some task on his or her behalf that requires some delegation of decision-making authority to the agent (Jensen & Meckling, 1976). Agency theory posits that this delegation of decision-making authority enables the agent to perform activities that favor his or her own interest over that of the principal. The decision-making authority that the agent has includes decision to present or to disclose information in the firm's annual reports and therefore, it needs control procedures that align the information need of the principal and the information provided by the agent.

Within the agency theory framework, shareholders or investors act as the principal and top corporate managers act as the agent (Fama & Jensen, 1983). Shareholders or investors have no direct control over the decision made by managers. Investors know that managers have the information, but they do not know what it is (Scott, 1997). To control managers' performance, investors usually rely on the information disclosed by managers in the annual reports. From the managers' point of view, all the information that is necessary for the optimal functioning of capital markets (Hendriksen & Breda, 1992) will be disclosed because they have incentives to keep the firm's share price from falling. A fall in share price will harm the managers through

lower remuneration (if remuneration is based on share price) or lower value on the labor market for managers.

Agency problems will arise when investors need sufficient information to permit predictions of companies' future trends, but management of companies do not disclose that information in the annual reports. This situation, in agency relationship literature, is known as information asymmetry. Asymmetric information refers to a situation where one group of individuals (the managers) is better informed (at least initially) than another group or the outside investors (Daing Nasir & Faoziah, 1994). The existence of information asymmetry in principal-agent relationship is increasingly being accepted in the literature and this has become an interesting issue to be studied. The decision of managers to disclose or not to disclose such information is dependant upon the situation those managers face. Disclosing all information will lead companies to face proprietary costs. Proprietary costs refer to the costs imposed on the firm if information disclosed can be used by external parties such as competitors, shareholders or employees in a way that is harmful to the firm (Craswell & Taylor, 1992; McKinnon & Dalimunthe, 1993). Accounting regulation attempts to reduce managers' ability to record economic transactions in ways that are not in shareholders' best of interests. Disclosure regulation sets forth requirements to ensure that shareholders receive information that is timely, complete, and accurate. In practice, disclosure in annual reports may exceed the mandatory disclosure requirements. Managers will disclose such information when they feel that it will lower their agency costs so that they have incentives to voluntarily disclose such information. Several studies indicate that benefits to enhance voluntary disclosure may include lower transaction costs in the trading of the firm's securities, greater interest in the company by financial analysts and investors, increased share liquidity, and lower cost of capital (Choi, Frost & Meek, 1999). This has become the

focus of interest by researchers who study voluntary disclosure. This is because actual disclosure in annual reports reflects managers' behavior and their responses to regulatory disclosure requirements.

Prior research into voluntary disclosures has been conducted in various countries, but it focused almost exclusively on the annual reports of companies in the developed countries (Choi, 1973; Firth, 1979,1980; Choi & Levich, 1990, Cooke, 1991; and Leung & Chi Moon, 1997). Choi (1973) investigated the changes in disclosure levels over a period of five years in 11 industrialized countries and concluded that firms entering the international market for external financing significantly improve their disclosure upon entry. In UK, Firth (1979,1980) examined the impact of firm size, stock market listing, and auditor presence on voluntary disclosure. He found that firm size and stock market listing were positively related to voluntary disclosure, but there was no relationship with the auditor variable. He also found that small firms improved their voluntary disclosures for the purpose of raising finance in the equity market.

In Australia, Leung and Chi Moon (1997) examined the association between voluntary disclosure choices and earning informativeness (defined as the ability of reported earning numbers to reflect a firm's future prospects to investor). The results provide some evidence in support of a link between firms' disclosure choices and the earning ability to reflect firms' future prospects. Firms with high earning informativeness are more likely to disclose earning forecasts, and firms with low earning informativeness are more likely to disclose operating information.

In Asia, Cooke (1991) investigated three variables (company's size, stock market listing, and industry type) that may influence such disclosures in the annual reports of Japanese corporations. Cooke concluded that all three variables would

influence the disclosure level and size was the most important variable in explaining variations in voluntary disclosure.

All of the researches on voluntary disclosure above were conducted in developed countries. Only a few research on voluntary disclosure practices were held in developing countries. For example, in Malaysia, Tong, Kidman, and Cheong (1990) examined the effect of size and auditor on the level of voluntary disclosure in Malaysian corporate annual reports. Their study found that the level of voluntary disclosure was positively associated with size but not with the auditors' influence. Another study in Malaysia was conducted by Hossain, Tan, and Adams (1994). They examined the relationship between size, ownership structure, leverage, assets in place, size of audit firm, and foreign listing status on the level of voluntary disclosure. They found that firm size, ownership structure, and foreign listing status were significantly related to the level of voluntary disclosure. In contrast, leverage, assets in place, and size of audit firm did not appear to be important factors in explaining voluntary disclosure by firms.

In Mexico, Chow and Wong Boren (1987) investigated the extent of voluntary disclosure and its relation to firm size, financial leverage, and the proportion of assets in place. The result showed that the extent of disclosure was significantly related to firm size, but not to the other two variables.

In Indonesia, prior research on voluntary disclosure is very rare. Only two studies concerning voluntary disclosures were conducted here by Subiyantoro (1997) and Suripto (1998). Subiyantoro (1997) examined the relationship between industry types (i.e. manufacturing and non-manufacturing) and financial mandatory disclosure (as opposite of voluntary disclosure). He found that the industry types did not affect the level of disclosure. Suripto (1998) examined the effect of industry types (banking and non-banking) and some other factors (i.e. size, leverage, liquidity ratios, firm's country

of origin, time listed in stock exchange, and frequency of stock issued) on the level of voluntary disclosure. The results show that only size and frequency of stock issued are statistically significant at the level of voluntary disclosure.

While the previous studies as described above mostly examined several firms' characteristics such as industry types, leverage, listing status, and size as factors affecting voluntary disclosures, this study will investigate the impact of two other factors that have not yet been included in the previous studies described above. These are the composition of the board of directors and the presence of the audit committee. There is an argument for including these factors in this study. The Indonesian Company Law of 1995 is the most important framework for the current legislation on corporate governance. Under the Company Law, a company is a separate legal entity. The board of directors and management represent the company. Although the ownership of listed companies is highly concentrated, and the percentage of managers belonging to the controlling group is also very high, rapid growth of Indonesian capital market and the need for better management due to business complexity during the last five years have caused some companies to start employing outside persons (professionals) to be members of board of directors and also to start having an audit committee to ensure better control in the companies' operations. Therefore, this has become an important issue to be studied in Indonesia.

The board of directors, according to Fama and Jensen (1982), is the highest internal control mechanism responsible for monitoring the actions of top management. They argued that outside directors have incentives to carry out their monitoring tasks and not to collude with top managers to expropriate stockholder wealth, so the inclusion of outside directors increases the board's ability to monitor top management effectively

in agency settings arising from the separation of corporate ownership and decision control. Outside directors are defined as all non-employee directors.

Existing empirical research provides evidence on the importance of outside directors on the board for purposes of monitoring management in acute agency settings. Lee, Rosenstein, Rangamand, and Davidson (1992) found that in management buyouts, shareholder wealth increase when boards are dominated by outside directors. Brickley and James (1987) stated that expenditures and salaries are negatively related to the percentage of outside members on the board of directors. Another study of Weisbach (1988) found that turnover of chief executive officers for poorly performing firms is highest with boards of directors having a high proportion of outside directors. The latter study by Beasley (1996) found that the board of directors' composition is an important factor for reducing financial statement, and the inclusion of outside members on the board of directors increases the board's effectiveness at monitoring management for the prevention of financial statement fraud.

While the studies described above support the prediction that board of director composition is related to the board's effectiveness at reducing agency costs and financial statement fraud, none has examined board of directors' composition in the context of voluntary disclosure practices in annual reports.

Based on this reason, this study examines variations in board directors' composition to test empirically the prediction that the inclusion of outside members on the board helps to increase the level of voluntary disclosure in the annual reports of Indonesian companies listed on the Jakarta Stock Exchange.

An audit committee is a sub-committee of the board of directors. The primary role of the audit committee is to provide an independent evaluation of a company's financial reporting functions. Typically this involves assessing both financial reporting

to shareholders and others (Fisher, 1994). In recent years, the audit committee has become a major means for companies to monitor the reliability of the financial reporting process. Several studies concerning the presence of audit committees have been conducted by many researchers. For example, Campbell and McNeil (1982) examined the relationship between audit committee and the changing of independent accounting firms. Pincus, Rusbarsky, and Wong (1989) examined the quality of audit committees to monitor the process of financial statement for users; and Henry (1994) examined the audit committee role in monitoring the management's selection of significant accounting policies.

In relation to the effectiveness of audit committees, Ali Abdul Hamid, Shamser, and Annuar (1999), in Malaysia, analyzed the internal auditor's perception of the effectiveness of audit committees. The findings suggest that the most effective roles of audit committees are reviewing the annual financial statements and interim reports, and reviewing the analysis of the adequacy of the internal accounting and financial controls of the company.

By referring to the discussion on audit committees above, none of the research have examined or explored the relationship between audit committees and voluntary disclosures. This issue seems interesting because as stated by Pincus et. al. (1989), audit committees are viewed as monitoring mechanisms that are voluntarily employed in high agency cost situations to improve the quality of information flow between principal and agent. The existence of an audit committee can be perceived as indicating higher quality monitoring and should have a significant effect on providing more information voluntarily to users of annual reports. For this reason, the present study examines the presence of audit committees and the extent of voluntary disclosures in annual reports of Indonesian public-listed companies. In Indonesia, the presence of an audit committee is

not regulated by both Indonesian Accounting Standard and Capital Market Executive Agency (or BAPEPAM) regulations. This is the reason why some companies have and others do not have audit committees.

Besides introducing the board of directors and the audit committee variables as new variables, the present study also uses some additional variables that were included in the prior research. These are firm size, leverage, profitability, firm operation, and industry types. These additional variables are examined since some previous research have shown contradictory results. Reasons cited for the differences are due to certain characteristics the country observed (e.g. standards required by regulatory bodies) as influential factors (e.g. political and economic development). For this reason, it is important also to include these additional variables in the study.

There are 9 categories of industries listed on the Jakarta Stock Exchange based on its product and operation characteristics. These are (1) agriculture, (2) mining, (3) basic industry and chemicals; (4) miscellaneous industry, (5) consumer goods industry, (6) property, real estate and building industry, (7) infrastructure, utilities, and transportation industry, (8) finance industry, and (9) trade, service and investment industry. Some previous studies included the industry types and their relation to the level of voluntary disclosure in several countries (e.g. McNally, Eng & Hasseldine, 1982 in New Zealand, Cooke, 1989 in Sweden, Cooke, 1991 in Japan, Subiyantoro, 1995 and Suripto, 1998 in Indonesia). The result varies, depending on the grouping of the industries of the country studied. The different and contradictory results of Cooke's studies in Sweden and Japan and Subiyantoro's (1995) and Suripto's (1998) in Indonesia precipitated this study which includes industry effect on voluntary disclosure practices in Indonesian companies.

Other variables in previous research such as number of shareholders, large auditing firms (Singhvi & Desai, 1971); assets in place (Chow & Wong-Boren, 1987; Bradbury, 1992; and Hossain et al., 1994) are omitted from this study. The number of shareholders and assets in place variables are highly correlated with size and hence its relationship with disclosure levels is likely to be similar to that of size. Due to the limited information about the size of auditing firms and only a few auditing firms can be perceived as large (those who have cooperation with foreign audit firms), this variable is not included. No hypotheses could be put forward for suggesting that foreign listing status should be associated with disclosure levels in Indonesia since only a few companies are listed in foreign stock exchanges, so these variables are not included in the analysis. Rate of return, and earning margins are indicators of profitability, so in this study those variables are assumed to be similar to profitability term.

In relation to the level of disclosure in a firm's annual report, there are two approaches to measure the level of disclosure (i.e. unweighted approach and weighted approach). These approaches use disclosure index as a basis for determining the level of disclosure. The unweighted approach assumes that each disclosure item is equally important. Once all the items have been scored, an index is created to measure the relative level of disclosure of a company. The index is a ratio of the actual scores awarded to a company to the scores that company is expected to earn. Consequently, a company is not penalized for those items that are not disclosed. This approach has been used in previous studies, i.e. Firth (1979, 1980), Cooke (1989, 1991), Hossain et al. (1994).

Another approach is a weighted approach. Weighted approach assumes that each item of disclosure is not equally important. The weighted score of each item is derived by using the score of importance awarded by external users of annual reports (Chow &

Wong-Boren, 1987). If a company disclosed an item, the actual weighted score of disclosure is calculated by multiplying the weighted score of that item disclosed by 1. The disclosure index of a company is a ratio of actual weighted scores awarded to a company to the total weighted scores that company is expected to earn. The level of disclosure of a company is represented by the disclosure index of a company. This study prefers using weighted approach because of three reasons: (1) this approach tends to support the fact that each disclosure item has different importance (or not equally important) in its usefulness for making decision by users, (2) companies, as preparers, have placed different emphasis on choosing items that should be disclosed in their annual reports, and this means that preparers have accorded different importance to each item, and (3) only a few previous studies used this approach.

To control subjectivity of assigning weights, this study has conducted a primary survey to determine the importance of the voluntary disclosure items perceived by both users and preparers of annual reports. The mean score of importance for each item is used as the basis (weight) for determining the level of voluntary disclosure of each company. This study also examines the reasons why management of company (as preparer of annual report) discloses the voluntary items in their annual reports.

Based on the discussion above, it can be summarized that the study on voluntary disclosure becomes a focus of interest by many researchers because the mandatory disclosure that is required or suggested in one country may be voluntary in another, and vice versa. Consequently, the amount of disclosure required and the voluntary disclosure items vary from country to country. Therefore, studies on voluntary disclosure have become a trend among researchers in many countries including Indonesia. There are at least two reasons why this study on voluntary disclosure is undertaken in Indonesia. These are: (1) most of the previous studies on