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Internet financial reporting, infrastructures and corporate governance: An international analysis

Kalu Ojah*, Thabang Mokoaleli-Mokoteli

Graduate School of Business Administration, University of Witwatersrand, P.O. Box 98, Wits 2050, Johannesburg, South Africa

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Abstract

Using a panel of 44 developed and developing countries, this paper analyzes the macro-environmental determinants of Internet financial reporting (IFR) within the context of corporate governance models, and thus, addresses the question of which governance model's disclosure demands are more associated with IFR. Both physical and institutional infrastructures are shown to be important determinants of a country's adoption of IFR. Along with the corporate governance structure, these infrastructures combine with IFR to enhance transparency and market efficiency, both major goals of financial reporting and disclosure. These findings point to requisite environmental infrastructures governments must provide or foster for firms within their confines to effectively adopt IFR and thus, reap the attendant benefits of disclosure. They also contribute to the debate on harmonization of international financial reporting by showing that requisite environmental infrastructures are a precondition for the success of any reporting system.

Keywords: Financial disclosure; Institutional infrastructures; Information asymmetry; Corporate governance; Market efficiency

1. Introduction

The realization of Internet's enormous benefits has led to its incorporation in many areas of production. Capital markets governance is one such area, as governments and regulatory bodies across countries have encouraged some Internet-based financial reporting and disclosure (e.g., SEC, 2002; Lymer and Debreceny, 2003, p. 104; and Regulation FD in the US). Financial reporting and disclosure are complementary means of ameliorating information asymmetry between managers and parties contracting with their firm, including shareholders, lenders, suppliers, customers, etc. (Ball, 2001) – and the resultant decline in opacity enhances financial markets efficiencies and reduces both cost of capital and investors' risks, among other advantages. Internet financial reporting (IFR) embodies this apt definition of "total disclosure",[1] and its adoption is a function of the demand for material information on firms by stakeholders. This demand is in turn systemically determined by the dominant corporate governance model in the country. Furthermore, the extent to which material information reaches stakeholders in a good form and time depends largely on the availability of requisite institutional and physical infrastructures that underpin IFR in the country.

The literature on financial reporting and disclosure depicts IFR as an embodiment of total disclosure that is aimed at reducing information asymmetry between shareholders and managers of a firm (Ashbaugh et al., 1999; Debreceny et al., 2002). It is an important way of resolving agency problems. Agency problems arise when managers entrusted with the responsibility of maximizing shareholders' wealth run the firm in ways that shareholders are unsure that managers' decisions are value-enhancing and not self-serving. These agency problems, when manifested

* Corresponding author. Tel.: +27 11 717 3764; fax: +27 11 717 3849.
E-mail address: Kalu.ojah@wits.ac.za (K. Ojah).
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[1] Ball (2001) defines "Total disclosure" to include both auditable company information (verifiability: relating to income statement, balance sheet and other financial statement items) and non-auditable information (future cash-flow-altering expectations: relating to R&D, M&A, managers' earnings forecast, and new market events). These varied kinds of information require a dissemination mechanism such as IFR which is characterized by content flexibility, reach, speed and economies of scale; particularly where stakeholders are dispersed and information asymmetry is important.

in value-decreasing investments or high opacity, tend to galvanize shareholders into the kind of activism aimed at increasing information on managerial decisions (Demsetz and Lehn, 1985; Rediker and Seth, 1995). Such transparency by management enhances the prudence of managerial decisions and congruency of shareholders and managers' interests; and ultimately mitigates agency costs (e.g., in the form of lower cost of capital) (Jensen and Meckling, 1976). In fact, the financial reporting and disclosure literature document a negative correlation between firms' increased disclosure and indicators of information asymmetry between firms and their stakeholders (Frankel et al., 1995; Botosan, 1997; Chen et al., 2007). Frankel et al. (1995) and Chen et al. (2007) highlight the point that the ultimate goal of increased disclosure is the reduction in cost of external finance (i.e., efficiency of financial markets) – whether this works through reduced information asymmetry premium, reduced liquidity premium or reduced agency cost that is attributable to enhanced corporate governance.

Guided by recent works on financial reporting and disclosure (Ball et al., 1999, 2000a,b; Kothari, 2000), we link the adoption of IFR to the corporate governance model for which it is most likely to meet the disclosure imperatives – i.e., under the *diffuse shareholder governance model* versus the *concentrated stakeholder ownership model*.[2] In the process, the need for either a governance model shift or a disclosure content modification for the adoption of IFR is highlighted. Potential requisite infrastructures for effective financial reporting and disclosure are discussed, with a sketch of how these infrastructures are linked to adoption of IFR.

Three key questions emanate from this framework of IFR adoption: (1) How important are macro-environmental factors in facilitating the adoption of meaningful IFR by firms in a country? In other words, upon accounting for the efficiency gain motivation for IFR adoption by individual firms, will firms in countries with varying enabling macro-environments be equally likely to adopt IFR? For IFRs to be "meaningful" and thus consistent with its depiction as an enhancer of total disclosure, it must, in content and form, be at par or better than paper-based financial reporting. (2) Do these varying cross-country macro-environments' resultant different corporate governance structures correlate differently with IFR adoption? For instance, given the agency literature's postulation that in the presence of information asymmetry managers are likely to choose a set of decisions that maximize their own utility, the adoption of IFR may be more useful in an environment characterized by the separation of ownership and control than otherwise. That is, the cross-country differences in corporate governance models and enabling physical and institutional infrastructures suggest a likelihood of international variation in the adoption of IFR, and consequently might require that it be discriminately embarked upon. (3) Upon taking into account prevailing macro-environments of a country, the dominant national corporate governance structure, and firm-specific efficiency gain motivations for adopting IFR, do firms' adoption of IFR still achieve the ultimate goal of enhanced efficiency of production (reduced cost of capital)?

These three main questions are subjected to robust empirical examinations. Briefly, there is strong evidence that both physical and institutional infrastructures determine the propensity of adopting IFR by a country, with four of the analyzed macro-environmental factors – computer/telecommunication infrastructure, financial market scope (economic), political and legal institutions – dominantly influencing a firm's adoption of IFR, even in the face of firm-specific efficiency gains of IFR usage. Further, the national corporate governance structure, which partly determines reach/speed of dissemination and content details of material information provided to firms' stakeholders, is found to play a role in the adoption of IFR. Importantly, IFR, as an embodiment of total disclosure, is found to retain its ultimate essence of reducing cost of capital even after considering other relevant factors such as macro-environmental infrastructures and dominant national corporate governance practice.

This study emphasizes the corporate governance context and thus, the agency cost mitigation of financial disclosure, by integrating the literatures on IFR adoption (Ashbaugh et al., 1999; Debreceny and Gray, 1999; and others) and the importance of financial disclosure and its linkages to infrastructure requirements (Ball et al., 1999; Kothari, 2000; Ball, 2001).[3] It examines financial disclosure across 44 governance environments (12 developed economies and 32 developing economies) and thus, provides useful comparative analysis. It breaks new ground by considering macro-environment predictors of firms' propensity to disclose financial information on the Internet. Prior works in the area focused primarily on firm-level analysis (Ashbaugh et al., 1999; Debreceny and Gray, 1999; Ettredge et al., 2002).[4] Importantly, we examine the robustness of the accepted notion that increased voluntary disclosure, by mitigating information asymmetry, ultimately reduces cost of capital (i.e., enhances market efficiency). Finally, the findings here contribute to the debate on harmonization of international financial reporting systems by showing, in agreement with Kothari (2000), Ball (2001) and others, that whichever reporting system is adopted will likely be ineffectual unless the enabling environments are provided first.

In the remainder of the paper, the background of the paper is presented: wherein the theoretical framework that underlines the pertinent testable hypotheses is laid out. Section 3 discusses the derivation of hypotheses. Next, the study's data are described.

[2] This grouping of corporate governance forms into two models is based largely on the prevalent corporate ownership structure in a country, as articulated by Kothari (2000): The diffuse shareholder model describes a governance arrangement where the corporation is owned mainly by widely dispersed, individually atomistic shareholders. The concentrated stakeholder ownership model describes governance arrangements where the corporation exhibits concentrated ownership by families, banks, government agents and workers.

[3] This integration is akin to Li's (2005) contextualization of information and communication technology application within relation-based and rule-based governance systems.

[4] Debreceny et al. (2002) is a notable exception. They consider the IFR-adopting firm's IT and disclosure environments in their analysis.