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Extent of corporate governance disclosure by banks and finance companies listed on Nepal Stock Exchange

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ABSTRACT

Corporate governance disclosure has seen renewed interest by researchers, policy makers, and regulating bodies internationally, but has remained only an emerging construct in Nepal. The primary purpose of this study was to assess the extent of mandatory corporate governance disclosure in Nepal. The secondary purpose was to examine the associations between the extent of disclosures and five firm-specific characteristics. The third purpose was to assess the significant determinants to explain variations of disclosures. The study's sampling frame consisted of 125 banking and finance companies listed on Nepal Stock Exchange. A sample size of 59 companies was randomly selected. On average, companies disclosed 91% of items in the mandatory category, 48% in the voluntary category, and 74% in total. A significant positive correlation existed between governance disclosures and firm characteristics of size, leverage, and foreign ownership. There was no significant relation between governance disclosure and listing age or profitability. With regards to determinants, bank size was a significant predictor of governance disclosure. Three regression models for total disclosures (DScore), mandatory disclosures [DScore (M)], and voluntary disclosures [DScore (V)] with three predictors of size, leverage, and foreign ownership were significant and explained 47%, 24%, and 54% variations respectively in total, mandatory, and voluntary corporate governance disclosures in Nepal. This research provides guidelines to policy makers and standard setters for developing future regulations and accounting policies.

1. Introduction

Mandatory disclosure is a regulatory tool and is the minimum framework of transparency (Brown, Goetzmann, Liang, & Schwarz, 2008). What is being disclosed needs to be authentic, attested, and based on generally accepted accounting principles and standards issued by accounting bodies. Disclosure can enable investors to avoid operational risk by ensuring a framework of transparency (Brown et al., 2008). Limited transparency puts demands on corporate governance systems to ease moral hazard problems (Bushman & Landsman, 2010) and the failure to disclose would signal the investors to assume the worst. Chen, Chung, Lee, and Liao (2007) concluded that poor corporate governance was usually accompanied by poor disclosure practices. As a result, poor governance induced higher levels of asymmetric information risk, which ultimately reduced the market liquidity of the stock (Chen et al., 2007). All these significant outcomes were crucial in keeping an efficient allocation of resources on the stock market (Arvidsson, 2011). Hence, disclosures are mandated by law as a regulatory mechanism so as to mitigate the agency problems arising as a result of separation of ownership and management of companies (Jensen & Meckling, 1976; Mahoney, 1995).

Financial companies, whether domestic or international, are required to have appropriate levels of corporate governance standards owing to their sensitive role in the economy to maintain credibility in the marketplace (Abraham, Deo, & Irvine, 2008), to secure their extensive dependence on depositors for capital (Boolaky & Thomas, 2010), and to maintain depositor confidence (Hossain & Reaz, 2007). However, the issue of corporate governance and its disclosure in the banking industry has not received the same level of attention in the research as other sectors (Turlea, Mocanu, & Radu, 2010) as the overall number of studies concentrating on governance-related disclosures is limited (Hooghiemstra, 2012). The exclusion of banks and financial institutions in many of the current international disclosure research and lack of recognition of countries like Nepal in such studies have further accentuated the problem (Adelpo, 2011; Akhtaruddin, Hossain, Hossain, & Yao, 2009; Arcot, Bruno, & Faure-Grimaud, 2010; Donnelly & Mulcahy, 2008; Kelton & Yang, 2008; Maingot & Zeghal, 2008; Thapa, 2008).

Banks and financial institutions have been excluded in previous research because they differ substantially from firms in other industries (Akhtaruddin et al., 2009; Arcot et al., 2010; Donnelly & Mulcahy, 2008; Kelton & Yang, 2008; Maingot & Zeghal, 2008). Hence, a dedicated study of this kind with only banks and financial institutions' disclosure will contribute to the literature without diluting the results. Moreover, this study can be considered timely owing to the recent media coverage about the banking financial

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crisis and the central bank official's opinion that "bad corporate governance" (Post Report, 2011) being the largest problem of the banking sector in Nepal. Internationally, Kirkpatrick (2009) argued that the global "financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements" (p. 1). Pokhrel (2007) and Asian Development Bank (ADB) (2010) had raised similar concerns about governance issues prevalent in listed companies, in Nepal. Pokhrel (2007) stated that concentrated ownership structure and family-dominance were major constraints in implementing good corporate governance in Nepal.

There are many potential negative consequences of such trends. First, it may impact the quality of earnings and firm value of companies (Ammann, Oesch, & Schmid, 2011). Second, the users may distrust the corporate disclosures (Bhuiyan & Biswas, 2007) because weak corporate governance and lack of transparencies are associated with an increased likelihood of adverse financial reporting (Carcello, Hermanson, & Ye, 2011). Third, weakens the stock market, brings about economic uncertainties, compromises investor protection, results in poor performance, and ultimately culminates into greater intervention by the government (Tsamenyi, Enninful-Adu, & Onumah, 2007). Similarly, companies may engage in selective disclosures by only disclosing those sets of indicators that would put them in the most favorable light (Sharma, Bejou, & Bejou, 2012).

The primary purpose of this non-experimental quantitative study was to assess the extent of mandatory corporate governance disclosure in Nepal in compliance to the requirements mandated by the disclosure regime there. A secondary purpose was to examine the extent of corporate governance disclosures and its relation with five firm-specific characteristics for banks and finance companies listed on Nepal Stock Exchange of Kathmandu, Nepal. The five firm-specific characteristics examined were: (a) size, (b) profitability, (c) leverage, (d) listing age, and (e) extent of foreign ownership of the bank. Considering the significant associations between the test variables, the study pursued further inquiry to identify significant determinants to explain variations in disclosure by examining associations between the criterion variables [DScore, DScore (M), and DScore (V)] and predictor variables of corporate size, profitability, and the extent of foreign ownership (Cooper & Schindler, 2008).

Agency theory provides the theoretical framework for this study with its structural platform for disclosure decisions (Kelton & Yang, 2008). This theory builds on the separation of ownership from control, manifested in most of the corporate forms of business. Jensen and Meckling (1976) popularized the theory, and they defined agency relation as a "contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some services on their behalf" (p. 5). Based on this relationship, Jensen and Meckling (1976) posited that the agent might not always act in the best of interests of the principal. Therefore, the principal incurred monitoring costs to limit the activities of the agent. On the other hand, agents incurred "bonding expenditures" to assure the principals. Hence, agency costs are generated by such contractual arrangements between the owners and top management of the corporation (Jensen & Meckling, 1976). Furthermore, Harford, Mansi, and Maxwell (2008) emphasized that "any discussion of the efficacy of corporate governance mechanisms … must address this issue" of agency conflict between the principal and agent (p. 535). Ntim, Opong, and Danbolt (2012) concurred that the disclosure of corporate governance practices was one of the key ways of resolving such agency conflicts. In concert with such views, there was an emerging international affirmation supporting the existence of an agency conflict of interest between owners and management (Henry, 2010). Henry (2010) suggested that the corporate governance disclosure might reduce the agency conflicts as a result of reduced information asymmetry. Similarly, Armstrong, Guay, and Weber (2010) viewed governance mechanisms as a set of contracts between the management and shareholders and said that information asymmetry played a role in mitigating agency conflicts between these parties. Greater compliance with the index comprising of the code of governance practice in Australia seemed to reduce the level of agency cost of Australian listed firms (Henry, 2010). Based on these premises and others, agency theory is a viable theory to study disclosures, especially by corporations. At times, regulation, an unconfined feature of banking, changes the boundaries of the agency relation by introducing a third party, the regulator (Islam, Islam, Bhattacharjee, & Islam, 2010). This further generates additional information asymmetries and associated agency problems. This causes a typical concern that any "moral hazard" brought about by regulation is a more forceful indicator of poor governance than is the simple conflict of interest anticipated between the principals (owners) and agents (managers) of commercial banks (Islam et al., 2010). Liberalization of the banking sector has intensified the moral hazard since it has allowed banks to undertake greater risks and the regulator, usually the central bank, will also share such risks as a "lender of last resort" (Islam et al., 2010). Boyd and de Nicoló (2005) provided another perspective of agency theory relating to the financial industry. Banks are "agents" for the depositors but are "principals" for their borrowers (Boyd & de Nicoló, 2005). These additional dimensions of agency theory and the banking industry's role in the recent economic upheavals justify the financial industry's selection as a sample (Bonsón & Flores, 2011) and agency theory as the theoretical foundation to study companies that are exposed to both governance contracting and debt contracting (Armstrong et al., 2010).

The study was important because corporate governance disclosure is considered a core component of corporate strategy for every public corporation especially in the current global context. According to Nicoló, Laeven, and Ueda (2008), corporate governance reform was one of the top priorities on the agenda of policy makers in many countries around the world. Bauwhede and Willekens (2008) were of the opinion that waves of scandals involving large corporations like Enron, Worldcom, and Parmalat in the most developed countries of the world had forced the business, and political leaders to make governance as one of their priorities to reinstate the public trust in capital markets. Cheung, Jiang, Limpaphayom, and Lu (2008) believed "improved corporate governance practices will lead to value maximization and provide an incentive for corporate managers to improve the quality of corporate governance practices" (p. 461).

This research provides significant guidelines to policy makers and standard setters for drawing up future regulations and accounting policies for listed companies in Nepal. The fact that there have been no studies in this area in the Nepali context, this research, will make a significant contribution in generating interest in the area for policy makers, companies and various users of company information. The research makes substantive contributions towards theory building by testing the predictions of agency theory in the financial sector. The research also provides empirical evidence, using correlation analysis and subsequently by multivariate analysis, about the potential determinants of varying levels of disclosure for banks and finance companies in a developing country like Nepal.

There are many reasons that Nepal's disclosure environment provides a unique opportunity to conduct the study. First, Nepal has a unique geopolitical situation, sandwiched between two giants—India and China. Second, Nepal is still experimenting with newfound democracy coming out of a long-drawn civil strife. Third, its capital market is still at its infancy; its regulatory environment is less matured and still developing. Fourth, the majority of listed companies on its exchange (NEPSE) are family-owned companies, and they have their own interpretations of governance. Hence, Nepal has its own distinct characteristics that influence the determinants and extent of disclosures made by listed companies. Therefore, this study provided a unique opportunity to expand the current body of knowledge about the extent of disclosure, determinants of such