CORPORATE GOVERNANCE, RISK DISCLOSURE AND COST OF EQUITY CAPITAL IN THE MALAYSIAN PUBLIC LISTED FIRMS

FARAHNAZ OROJALI ZADEH

UNIVERSITI TEKNOLOGI MALAYSIA

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FARAHNAZ OROJALI ZADEH

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DEDICATION

This work is dedicated to my husband, Alireza and my son Aidin for their support and unconditional love.

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ABSTRACT

Risk disclosure has received considerable attention in today's business world. However, there is a lack of research on the practices and trends of risk disclosure. Therefore, there is a need to examine the trend of risk disclosure over years as well as the determinant and consequence of risk disclosure. In particular, this study examined risk disclosure level, the influence of corporate governance on the risk disclosure level, and the impact of risk disclosure level on cost of equity capital. The secondary data for the study were based on annual reports, DataStream and Capital IQ of firms from non-financial firms listed on the Main Board of Bursa Malaysia from 2001 to 2011. Level of disclosure was measured using content analysis. Two empirical analyses were examined using multiple regressions. The content analysis findings confirmed a trend toward greater levels of risk disclosure. Firms disclosed risk on financial, non-financial and risk management framework respectively. Most of the information disclosed is either neutral or good, while bad news was infrequently reported. Firms risk disclosure also includes both monetary and non-monetary disclosures and firms tend to report more information about past risks rather than future risks. The results of the first empirical analysis show the significant and positive relationship between board size, independent non-executive directors, and audit committee independence with risk disclosure level but there is no significant relationship with ownership structure and race of the chairman. The second empirical analysis suggests firms with high level of risk disclosure will yield lower cost of equity capital. Overall, findings are consistent with political cost theory, agency theory, capital need theory and signaling theory. The findings have shown the importance of risk disclosure practices and it is recommended that policy makers, authorities and boards of directors to consider the disclosure of risk in a firm's annual reports as a priority.

ABSTRAK

Pendedahan risiko telah mendapat perhatian dalam dunia perniagaan hari ini. Walau bagaimanapun, masih terdapat kekurangan kajian mengenai amalan dan arah aliran pendedahan risiko. Oleh itu, terdapat keperluan untuk mengkaji arah aliran pendedahan risiko dan juga penentu dan akibat daripada pendedahan risiko. Secara khususnya, kajian ini meneliti tahap pendedahan risiko, pengaruh tadbir urus korporat kepada tahap pendedahan risiko, dan kesan tahap pendedahan risiko kepada kos modal ekuiti. Data sekunder untuk kajian ini adalah berdasarkan laporan tahunan, Datastream dan Capital IQ firma-firma dari syarikat bukan kewangan yang disenaraikan di Papan Utama Bursa Malaysia dari tahun 2001 hingga 2011. Tahap pendedahan diukur menggunakan analisis kandungan. Dua analisis empirikal telah diuji menggunakan regresi pelbagai. Dapatan kajian analisis kandungan mengesahkan arah aliran pendedahan risiko ke tahap yang lebih tinggi. Firma mendedahkan risiko masing-masing berkaitan kewangan, bukan kewangan dan kerangkakerja pengurusan risiko. Kebanyakan maklumat yang didedahkan adalah sama ada neutral atau baik, manakala berita yang buruk jarang dilaporkan. Pendedahan risiko firma juga termasuk kedua-dua pendedahan berdasarkan kewangan dan bukan kewangan dan firma-firma cenderung untuk melaporkan lebih banyak maklumat mengenai risiko yang lepas berbanding dengan risiko pada masa hadapan. Keputusan analisis empirikal yang pertama menunjukkan hubungan yang signifikan dan positif antara saiz lembaga pengarah, pengarah bukan eksekutif bebas, dan kebebasan jawatankuasa audit dengan tahap pendedahan risiko tetapi tiada hubungan yang signifikan dengan struktur pemilikan dan etnik pengerusi. Analisis empirikal kedua mencadangkan firma dengan tahap pendedahan risiko yang tinggi akan menghasilkan kos modal yang lebih rendah. Secara keseluruhan, dapatan adalah konsisten dengan teori politik kos, teori agensi, teori keperluan modal dan teori isyarat. Dapatan kajian telah menunjukkan kepentingan amalan pendedahan risiko dan dicadangkan supaya pembuat dasar, pihak berkuasa dan lembaga pengarah untuk mengambilkira pendedahan risiko dalam laporan tahunan firma sebagai satu keutamaan.

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AASs	-	Australian Accounting Standards
ACINDE	-	Audit Committee Independence
AICPA	-	American Institute of Certified Public Accountants
AIMR	-	Association of Investment Management and Research
ASB	-	Accounting Standards Board
B	-	Bad
BETA	-	Beta
BOD	-	Board of Directors
BRDSIZE	-	Board Size
CA 1965	-	Companies Act 1965
CAPM	-	Capital Asset Pricing Model
CEC	-	Cost of Equity Capital
CG	-	Corporate Governance
CMP	-	Capital Market MasterPlan
COEC	-	Cost of Equity Capital
COR	-	Corporate
COSCO	-	Pertubuhan Keselamatan Sosial
CRD	-	Corporate Risk Disclosure
DDM	-	Dividend Discount Model
EPS	-	Earnings per Share
EPF	-	Employee Provident Fund
F	-	Future
FASB	-	Financial Accounting Standards Board
FCCG	-	Finance Committee on Corporate Governance
FOR	-	Forecast Information
FR	-	Financial Risk
FRA	-	Financial Reporting Acts

FRF	-	Financial Reporting Foundation
FRS	-	Financial Reporting Standards
G	-	Good
GASB	-	German Accounting Board
GASs	-	German Accounting Standards
GDP	-	Gross Domestic Product
GFC	-	Global Financial Crisis
GLS	-	General Least Squares
GRWTH	-	Growth
IAF	-	International Accreditation Forum
IASB	-	International Accounting Standards Board
IASs	-	International Accounting Standards
IFRS	-	International Financial Reporting Standards
ICAEW	-	Institute of Chartered Accountants in England and Wales
IIAM	-	Institute of Internal Auditors Malaysia
INDNED	-	Independent non-executive directors
IPO	-	Initial Price Offering
KLCI	-	Kuala Lumpur Composite Index
KLSE	-	Kuala Lumpur Stock Exchange
LVRGE	-	Leverage
LTAT	-	Lembaga Tanbung Angkatan Tentera
MO	-	Monetary
MA	-	Mandatory
MASB	-	Malaysian Accounting Standards Board
MCCG	-	Malaysian Code of Corporate Governance
MESDAQ	-	Malaysian Exchange of Securities Dealing and Automated Quotation
MFRS	-	Malaysian Financial Reporting Standards
MIA	-	Malaysian Institute of Accountants
MICG	-	Malaysian Institute of Corporate Governance
MICPA	-	Malaysian Institute of Certified Public Accountants
MSWG	-	Minority Shareholders Watchdog Group
N	-	Natural
NEAC	-	National Economic Action Council

NFR	-	Non-Financial Risk
NM	-	Non-Monetary
OLS	-	Ordinary Least Squares
OWNRSHP	-	Ownership Structure
P	-	Past
PERS	-	Private Entity Reporting Standards
PLC	-	Public Listed Companies
PNB	-	Perbadanan Nasional Berhad
RACECH	-	Race of Chairman
RDL	-	Risk Disclosure Model
RIM	-	Residual Income Model
RMC	-	Risk Management Committees
RMFW	-	Risk Management Framework
RRD	-	Risk Disclosure Level
SC	-	Securities Commission
SCA	-	Securities Commission Act
SD	-	Standard Deviation
SIZE	-	Firm Size
SPV	-	Stock Price Volatility
STR	-	Strategic Background Information
STT	-	Stock Trading Turnover
UK	-	United Kingdom
V	-	Voluntary
VaR	-	Value-at-Risk
VIF	-	Variance Inflation Factor
VLME	-	Volume

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CHAPTER 1

INTRODUCTION

1.1 Overview

This chapter provide introduction to the study, which is organized by the following sections: Section 1.2 provides the background of the study. Section 1.3 introduced and discusses the problem statements, while section 1.4 and section 1.5 focus on the research objectives and questions, followed by section 1.6 that highlights the significant of the study. Section 1.7 and section 1.8 explain the scope of the study and the outline of the thesis. The chapter concludes with a conclusion of the chapter in section 1.9. Section 1.10 provides the terminologies of the study.

1.2 Background of the Study

Risk is referred to as the uncertainties that are linked to a potential loss or profit (Cabedo and Tirado, 2004; CICA, 2002; IASB, 2005; ICAEW, 1997; Linsley and Shrives, 2005; Solomon *et al.,* 2000). Organizations are facing various types of risks and the need to prioritize those risks is an important component of the risk management operation (ICAEW, 1997). Risk management is a critical component in business; and incorporates identifying and measuring risks. Santomero (2007) suggested that in order to implement a sound risk management system in an organization, it is important to include risks reports in the organization's financial reports and to present to shareholders and regulators. Raghavan (2003) added that it is necessary for organizations to disclose adequate risk information since it would help potential investors to examine the strategies adopted by the organizations in this area.

Thus, the identifying, managing and disclosing of risks have been the recent focus of lawmakers, policy makers and mandatory reporting procedures applied in the international context (Hill and Short, 2009). Risk reporting information has been disclosed based on some regulatory framework. At the same time, some companies disclose extra information voluntarily. Greater risk disclosure will enable firms to be more transparent. Users of corporate reports are also able to assess the risk profile of the firm to make better investment decisions. This will reduce information asymmetry leading to a decrease in the cost of equity capital (Botosan, 1997; Chen and Gao, 2010; Hail, 2002; Solomon *et al.*, 2000).

Institutions that set standards for risk reporting and disclosure in companies' annual reports have given considerable focus to risk reporting, due to the critical nature of risk. However, it has been found that the availability of risk information is still inadequate in these reports (Abraham and Cox, 2007; Amran *et al*., 2009; Elzahar and Hussainey, 2012; Konishi and Ali, 2007; Lajili and Zéghal, 2005; Linsley and Shrives, 2006; Oliveira *et al.*, 2011a; Woods and Reber, 2003). In fact, the users of the annual reports have increased their demand for the availability of such information in annual reports so that they can assess the organizations' risk profiles better (Linsley and Shrives, 2000, 2005; Solomon *et al.*, 2000). Given the increased request for more risk information, regulators and other involved parties are playing a bigger role in introducing new policies that could enhance the risk reporting system (AICPA, 1994; ASB, 1993, 2003, 2006; CICA, 2002; ICAEW, 1997, 1999b, 2002). In Malaysia, argument on risk management and its requirement for disclosure can be clearly established in the Financial Reporting Act 1997 and Bursa Malaysia listing requirements (Amran *et al.*, 2009). The listing requirements suggest that listed firms are obligated to disclose their financial, operation and management information in their annual reports for a particular financial period so that stakeholders and investors would be able to assess the performance of the firm.

Several empirical studies provide evidence that various firm determinants affect corporate risk disclosure levels (Elshandidy *et al.*, 2013). For corporate governance mechanisms, Taylor *et al.* (2010) argued that firms with strong corporate governance structure are more effective in financial risk management; that is reflected as enhanced financial risk disclosures. In the Malaysian context, the code of corporate governance highlights the importance of companies to disclose their risks in the annual report (Amran *et al.,* 2009). Investigation on the corporate governance factors and the level of risk disclosure is one of the interesting areas for researchers which leads to the appearance of a number of studies in accounting literature that focus on clarifying the effect of best practice and corporate governance codes on the risk disclosure level.

A greater disclosure reduces the information asymmetry and investor uncertainty, resulting in a positive effect to reduce the firm's cost of equity capital (Botosan, 1997; Chen and Gao, 2010; Easley *et al.,* 2001; Eaton *et al.,* 2007; Hail, 2002; Shi and Kim, 2007). Companies can be transparent and reduce uncertainties through identifying, managing, analyzing and evaluating risks, which will be useful for assisting corporate reports users and investors in the capital market to understand the risk profiles. These functions will help them to accurately assess a firm's financial condition and performance (Cabedo and Tirado, 2004; Lev and Zarowin, 1999; Solomon *et al.,* 2000). Another argument by Lev (1988), Akerlof (1970) and Shi and Kim (2007) holds that the disclosure is important for any function in capital markets. Any kind of disclosure such as risk helps well-known, confident and well-informed investors to make decisions accurately in the stock market (Cabedo and Tirado, 2004; Deumes, 2008). There is a negative link between the cost of equity capital and the level of disclosure in the countries with low disclosure environment (Kristandl and Bontis, 2007; Lopes and de Alencar, 2010). Managers in such countries are persuaded to offer a greater disclosure on a voluntary basis to reduce the uncertainty among the stakeholders and investors (Souissi and Khlif, 2012). Therefore, along with this development, there is a growing need for disclosing firms' information particularly risk disclosure. Previous researches (Solomon *et al.*, 2000, Linsly and Shrives 2006) provide evidence that investors regard the disclosed information by the firm (risk information is considered as the critical part of this information) as an important source of decision making. In line with this; the statement of the problem is the subject of discussion in the following section.

1.3 Problem Statements

Given the rapid changes occurring in global business and their effect on society and governments, the demand for information has also grown tremendously. A major transformation was observed following the financial crisis in South East Asian economies in 1997. The financial crisis affected the South East Asian countries badly resulting in major losses, which lowered the confidence level of investors in the stock markets. In Malaysia, because of this crisis, the government decided to improve policies so that the economy could be improved and to bolster investor confidence in the capital market. In 1998, the National Economic Action Council (NEAC) was set up to initiate plans for sustained growth in the country. The NEAC proposed plans to improve firms' corporate governance, transparency, and accountability in order to regain market confidence (Mohd Ghazali and Weetman, 2006).

The government of Malaysia, in 1998, incorporated a high level Finance Committee to assess corporate governance in order to improve the process. The Malaysian Institute of Corporate Governance (MICG) was established at the same time to create awareness and provide information regarding corporate governance. The Malaysian Code on Corporate Governance (MCCG) which was established in 1999 shows the best practices for corporate governance, however, in the earlier years, adhering to the MCGG was encouraged but not enforced. The Kuala Lumpur Stock Exchange (KLSE), in 2001, enforced a ruling that needed companies with their financial year end after the 30th of June 2001 to comply with the MCCG requirement, to highlight their risk management strategies and internal controls in their annual reports. Later on, MCCG 2007 and MCCG 2012 were introduced. In a survey by Mohd Ghazali (2012), 35.6% of the responding companies had a risk management committee following the MCCG (2007) revision of their policies. This shows a positive outlook on the companies' part in establishing corporate governance in the country.

As such, according to the Financial Reporting Act of 1997, based on the corporate governance code, firms had to develop an explicit risk management disclosure plan that must include financial, management and operation disclosure, so that the stakeholders and investors would be able to assess firm performance. Additionally, they had to include three areas of reporting namely, the practiced corporate governance, the level of internal controls and risk management, and mitigation plans. In addition and according to the role of accounting standards as provided by MASB (Malaysian Accounting Standards Board), companies had been mandated to adhere to the standards which highlighted that the highest risk matters must be disclosed in annual reports, as stated in MASB24 in Jan 2002, MASB8 in Jan 2002, FRS124 in Oct 2006; FRS132 in 2006; FRS 137 in July 2007; FRS7 in 2010; and FRS139 in 2010. Another regulatory body by the Securities Commission regulations, mandated that the company holds exchange in the capital market must also disclose all risks associated with the investors and company (section 212 in the Capital Markets and Services Act 2007).

According to political costs theory, a company is required to meet any requirement from regulators in disclosing information, which supports investors of the company to make perfect decision. The regulations on risk disclosure are methods to increase the standard of disclosure. Policies are very much needed in an imperfect markets, whereas, in a perfect market such implementations may not be required. Healy and Palepu (2001) suggested that policies on disclosure are needed to create a more efficient market and they have an influence on the credibility of the financial reporting system. In line with political cost theory, this study aimed to address the contextual gap, as there have been not many studies in imperfect market and developing country context, to investigate the amount and type of information revealed in annual reports.

There is a limited number of studies investigated the trend of risk disclosure (Rajab and Handley-Schachler, 2009). It is difficult to make a comparison on the levels of risk disclosure between different nations, because the regulations differ from one to the other. However, studies on trend of risk disclosure of a particular nation over years will be beneficial to determine the strength and weaknesses of the current rules. To the knowledge of the author, there is no study which investigated the trend of risk disclosure over the recent years in the Malaysian companies' context. Hence, this research intended to investigate the trend of risk reporting over a period of 11 years to examine whether reporting in annual reports are in line with the regulators guidelines and also meet the requirements of the various accounting bodies in Malaysia following the financial crisis in 1997. It examined if there were any changes and variations of risk disclosure practices in annual reports. It is necessary to explore the development of risk disclosure in view of new policies, rules, standards setters and corporate governance practices. According to political costs theory an organization's risk disclosure reporting should be reflective of the new policies made by regulators.

According to Schipper (1991), the agency theory anticipates that certain disclosures in annual reports could be used as a tool to decrease the monitoring costs of shareholders and reduce the problems of moral hazards. Disclosure is used as a tool in decreasing the unwanted impacts of moral hazards and selection allegations. Disclosure is a tool to motivate shareholders and related stakeholders that the firm is properly managed and is made accountable. Disclosure tends to reduce agency cost and improve the confidence of the investors in firms as well as decrease information asymmetry. The agency theory suggests that agency cost differs according to the firm's corporate governance factors. Agency theory is quite useful in describing the uncertainty and risk disclosure. Knowing the risks that are disclosed would enable the investors to manage risk diversification well. This study investigated the usefulness of risk disclosure according to the agency theory and addressed the gap in the literature to support and describe risk disclosure practices in a developing country. Most of the previous studies have been conducted in developed countries with a perfect market. The development of CG codes in Malaysia has led the author to examine the relationship between CG and risk disclosure. It was expected that improvement in CG practices would increase level of risk disclosure which in turn lead to a reduction in conflict and agency costs.

Given the current financial developments and accounting requirements, the area of risk reporting has gained a lot of attention from accounting researchers. They focus on prospectus (Deumes, 2008; ICAEW, 1999b; Papa, 2007), quantitative method, and various classification (Dunne *et al.*, 2007; Jorion, 2002; Li and Gao, 2007; Linsmeier and Pearson, 1997; Linsmeier *et al*., 2002; Mohd Ghazali, 2012; Rajgopal, 1999; Roulstone, 1999; Seow and Tam, 2002). Several studies have concentrated on risk information and assessed the disclosure of risk in annual reports.

Woods and Reber (2003) and Berger and Gleißner (2010) studied the area of disclosure of risk in annual reports but they failed to investigate the potential variables of the disclosure. On the other hand, several studies carried on risk disclosure determinants, that examine the relationship of factors that included board composition, environmental sensitivity, audit committee, ownership structure, size, profitability, leverage, and auditor quality with the extent of risk disclosure (Abraham and Cox, 2007; Abraham *et al.*, 2007; Amran *et al.*, 2009; Beretta and Bozzolan, 2004; Elshandidy *et al.*, 2013a; Elzahar and Hussainey, 2012; Konishi and Ali, 2007; Linsley and Shrives, 2006; Mousa and Elamir, 2014; Oliveira *et al.*, 2011a; Rajab and Handley-Schachler, 2009) however, some of the results were inconclusive and there were many other factors that were not considered.

In Malaysia, studies on risk disclosure are still limited. A study by Mohd Ghazali (2012) examined the perspective of corporate managers in a survey related to disclosure of risk and risk management. Another study by Amran *et al.* (2009) investigated only a few company characteristics such as industry, leverage and size in Malaysia. There are many other variables that could be studied. This study extended previous research by adding more variables of corporate governance, which is still under researched. Four corporate governance variables (ownership structure, board size, independent non-executive directors, and audit committee independence) were chosen due to lack of studies on them to date. These are exploratory variables in Malaysia and inconclusive, mixed results by previous findings, with several of the relationships not well established resulting in the absence of consensus among the researchers. Based on cultural theory which discusses religion and race effect on the corporate behavior and reporting practices; as such the policies for disclosure might be affected by a person's religion, race and behavior based on cultural aspects (Haniffa and Cooke, 2002; Mohd Ghazali, 2004). So there is need to explore this relationship. According to Mohd Ghazali (2004) and Haniffa and Cooke (2002), there is a positive and significant relation between the number of directors on a board who are Malays and voluntary disclosure in annual reports in Malaysian firms. This study was anticipating similar outcomes in the practice of risk disclosure and proposing that there is a relationship between race of chairman on a board who are Malays and Muslim and risk disclosure level.

The issue of whether indeed it is beneficial for a company to increase disclosure via a reduced capital cost remains a controversy among company management, policy makers and scholars. This is regardless of the fact that the American Institute of Certified Public Accountants' final reporting committee in 1994 states that greater disclosure leads to a lowering of cost of capital. Moreover, Beyer and Guttman (2012) fuel the uncertainty of such a relationship between increased level of disclosure and lowering of cost of capital by maintaining that this issue is still a question of interest among accountants and financial analysts in the literature.

The debate on the relationship between disclosure and cost of equity capital continues unabated. Theory has provided a strong support for the negative association between these two variables (Diamond and Verrecchia, 1991; Easley and O'hara, 2004). Some theorists such as capital need theory and signaling theory argue that more disclosure will result in lowered cost of equity capital due to the reduced estimates of risks and transaction costs (Armitage and Marston, 2007; Botosan, 1997; Chen and Gao, 2010). Many empirical studies have been conducted since 1997 to try and support the theory. At the onset, the literature provided evidence of works that highlighted how voluntary disclosure was associated with cost of equity capital particularly in developed markets such as the USA (Botosan, 1997), Canada (Richardson and Welker, 2001), Switzerland (Botosan and Plumlee, 2002; Hail, 2002) and the UK (Gietzmann and Ireland, 2005). Not so long ago, emergent markets and civil law countries have also shown much interest in this topic, Zhang and Ding (2006) in China; Espinosa and Trombetta (2007) in Spain; Kristandl and Bontis (2007) in Austria, Germany, Sweden; Déjean and Martinez (2009) in France; (Embong et al., 2012) in Malaysia, Lopes and de Alencar (2010) in Brazil and Miihkinen (2013) in Finland). Despite all the work done, substantial empirical evidence is still lacking and the many inconclusive and varying results leave the question of the association between corporate disclosure and cost of equity capital still unanswered.

Therefore, in terms of risk reporting, the current literature only offers a partial concern of risk disclosure practices, its features and governing factors. A few studies by Chen and Gao (2010) and Rajab (2009) examined the effect of risk disclosure on cost of equity capital and they found mixed results and there is no similar argument for this relationship. Therefore, there is a need for more studies to conclude the result between risk disclosure and cost of equity capital. There is a crucial need for the examination of how this information is being disclosed and to find out the potential benefits of disclosure of risk information such as in the impact it has on the firm’s cost of capital. Moreover, there is a lack in the studies of the potential influence of risk disclosure on the components of cost of equity capital. Hence, this study aims to address this gap in the accounting literature as it concentrates on the situation in Malaysia in order to discover the association between the extent of risk disclosure and cost of equity capital.

Furthermore, unlike previous studies (Amran *et al.,* 2009) that used risk categories, which are mainly utilized for the developed countries, this is the first study that used risk categories, which is more suitable for Malaysia. The categories for risk disclosure in this study was based on Oliveria *et al.* (2011a) which has been assured for validity and reliability of content analysis tested in the emerging market. This study also addresses the methodological gap by studying risk disclosure based on the following classification that is more suitable for emerging market: financial, nonfinancial, and risk management framework and also the economic sign (monetary, non-monetary), type of measure (past, future), outlook (good, bad, neutral), and type of disclosure (voluntary, mandatory).

1.4 Research Justification

Given the current financial developments and accounting requirements, the area of risk reporting has gained considerable attention by accounting researchers. Even though there have been many studies covering this topic, the focus of each of these studies differed. Some of the past studies have investigated risk disclosure specifically in financial statements based on a quantitative method and others have concentrated on various classifications of risk (Jorion, 2002; Li and Gao, 2007; Mohd Ghazali, 2012; Rajgopal, 1999; Seow and Tam, 2002). Several studies have concentrated on a more general approach to risk information and assessed the disclosure of risk in annual reports (Abraham and Cox, 2007; Lajili and Zéghal, 2005; Linsley and Shrives, 2005, 2006) and in prospectus (Deumes, 2008; Papa, 2007). However, the researches on the broader area of risk information are limited. For example, Lajili and Zéghal (2005); Woods and Reber (2003) and Berger and Gleißner (2010) studied the area of disclosure of risk in annual reports but they failed to investigate the potential determinants of the disclosure. Linsley and Shrives (2005) investigated the disclosure of risk among non-financial based UK firms; besides risk level and firm size, they did not assess any other determinants. On the other hand, several researches carried on risk disclosure determinants such as corporate governance and companies characteristic have yielded inconsistent findings (Abraham and Cox, 2007; Abraham *et al,* 2007; Amran *et al.,* 2009; Beretta and Bozzolan, 2004; Elzahar and Hussainey, 2012; Konishi and Ali, 2007; Linsley and Shrives, 2006; Oliveira *et al.,* 2011a; Rajab and Handley-Schachler, 2009).

The area of literature on accounting disclosure shows some of the current and past issues that have been examined includes finding out what is contained within the reports by the firms, the rudimentary issues that have an influence on the information contained with the reports and the motivation behind firms reporting on such disclosure of information. Even though there have been extensive studies on the area of types of risk related information is being disclosed, there is a crucial need for the examination of how these information is being disclosed and to find out the corporate governance factors which influence the level of risk disclosure and potential benefits of disclosure of risk information on the firm’s cost of equity capital. The existing literature only provides a portion of disclosure practices, its characteristics and factors that govern it in terms of reporting risk; however, there are not many studies to show the influence of disclosing the risk information and its effects on the company's cost of equity capital. Thus, this research aims to address this gap. The first objective of this study is to research about risk disclosure practices in the corporate world by studying the annual report for eleven consecutive years (2001-2011), to figure out whether or not there is a difference between the variety and extent of disclosure over time, and hence this can be classified as a longitudinal study. The main intention is to draw a clear picture regarding the volume and type of altering patterns of reporting and hence focus on the limitations of reporting risk. Even though previous literature has explored risk disclosure, a limited number of them have examined it from a point of view of current trends and whether companies have been able to react to the external pressure and demand for information related to risk. It is interesting to research about how risk disclosure has evolved over the past years as a response to the creation of the new codes of corporate governance, hence addressing the gap created by political cost theory. The existing studies on different types of disclosure including social and environmental indicates that corporate social reporting has risen in time due to various factors. Haniffa and Cooke (2005) believed that some of these factors could include increased legislation events, pressure group activities, politics and social awareness. The risk reporting of a firm must develop based on the codes and rules of corporate governance in the past few years.

The second aim of this research was to provide an explanation for any variations in the risk disclosure and analyze what elements determine the degree of risk disclosure. Accounting researchers have always been curious about the link between disclosure and its determinants. The degree of corporate disclosure can be affected by various components including financial and non-financial, social and corporate governance factors. But, a number of the relationships between the factors have not been proven valid in the existing literature. However, the results and conclusions of prior studies provide good starting point to develop and understand the relationship between risk disclosure and the fundamental organizational elements.

The third goal of the study was to analyze the actual usefulness of disclosing risk in the annual reports. Earlier researches and studies provide a perspective into the perceived benefits and costs along with perceived usefulness of disclosure. Gray and Roberts (1989), Ajili and Zeghal (2005), Soussie and Khalif (2012), AICPA (1994) for instance, insisted that disclosure helps develop a positive brand image as well as aid in making the right business decisions. Disclosure can also be regarded as one of the methods to reduce adverse selection by mitigating the information imbalance between the managers (or preparers) and the investors (or users). Disclosure helps to reduce the firm's cost of capital and transaction costs (which has resulted from lower bid-ask spreads) while increasing share liquidity. Furthermore, proper disclosure also allows organizations to maintain positive relationships with all their stakeholders in order to preserve their support. In addition, disclosure also helps in keeping clear of regulatory pressure and hence allows firms to avoid further requirements.

The corporate reporting community has always been curious regarding whether the greater the level of disclosure of a company would result is a lower cost of equity for the firm. However this issue has been much debated upon (Botosan, 1997; Sossie and Khalif, 2001). The theoretical discussions state that greater disclosure is related to lower cost of equity because of the reduced estimation risk and lowered transaction costs. The ICAEW also supports full disclosure, as they believe that a company that discloses risk information will create a brand image of them being riskier than prior to disclosure. The disclosure of risk motivates its management and decreases the volatility of the stock; hence, reducing the firm’s cost of capital. The reporting of risk information is crucial especially for potential investors. The more aware they are of the potential risks, the better they would be able to attach value and determine the cost of capital for the firm. However, as a drawback, this theory does not have sufficient empirical evidence to substantiate it. For instance, the Jenkins committee notes that the greatest benefit of risk disclosure is the reduced cost of capital (AICPA, 1994). On the other hand, the financial executive institute (Berton, 1994; Botosan, 1997) stated that increased disclosure would target the stock traders hence, increasing the volatility of the share price and as a result increasing risk which results in higher equity capital cost.

In the report from ICAEW (1999b) a number of skeptics underline the fact that “a more accurate capital cost does not necessarily mean a lower capital cost and an increase is level of disclosure might result in increased cost of capital ICAEW (1999b). It can also be said that firms that do have higher risk rates may not be hesitant to disclose such information because they do not wish to draw attention to their riskiness but rather wish to divert attention from it. Other evidence such as Armitage and Marston’s (2007), show that finance representatives do not believe that there is not a clear relationship between cost of equity and levels of disclosure because their respective companies already disclose enough information. It can be reasoned that it is when the potential investors feel as though the information disclosed by the company is valid and credible will the risk disclosure in annual report have any effect on reducing the firm's cost of capital. Although the disclosure of risk is mandatory in annual-reports, the latest regulations provide the company with the power to only disclose certain amounts and levels of risk information. This means that the active disclosure of right information depends on the willingness of the manager (Deumes, 2008). After reviewing the current studies and literature (ICAEW, 1997, 2004b; Linsly and Shrives, 2000; Woods and Reber, 2003, Lajili and Zegal, 2005), it becomes evident that there still is a need for empirical work to investigate the effect of risk disclosure on a firm's cost of equity capital. For the Malaysian context, this is a first study which elaborates the risk reporting practices over eleven year to investigate the trend of risk disclosure keeping in line with regulatory development. It could also be the first study that investigates the corporate governance factors and risk disclosure as well as the effect of risk disclosure on the cost of equity capital and its proxies. The following sections provide the research questions and objectives.

1.5 Research Questions

The following are the research questions answered in this study:

RQ1: What is the trend of risk disclosure in the Malaysian non-financial companies' annual report over 11 years?

RQ2: Does corporate governance factors such as ownership structure, board size, independent non-executive directors, audit committee independence, and race of chairman on the board influence level of risk disclosure?

RQ3: Do the risk disclosure practices affect the cost of equity capital from the years 2001-2011 in Malaysian non-financial companies?

1.6 Research Objectives

This study aims to achieve the following objectives:

Objective 1: To investigate the trend of risk disclosure in Malaysian companies' annual report over 11 years from 2001-2011.

Objective 2: To investigate the association of corporate governance factors such as ownership structure, board size, independent non-executive directors, audit committee independence, and race of chairman on the board on the extent of risk disclosure.

Objective 3: To investigate the impact of risk disclosure practices on the cost of equity capital for the years 2001-2011 in Malaysian non-financial companies.

1.7 Significance of the Study

After reviewing the current theories, this research adds to the current literature by examining the disclosure of risk in terms of the risk types by comparing the risk disclosure for a period of eleven years. Longitudinal studies are important as the previous studies are not so relevant to the current objective (ICAEW, 1999). This longitudinal research, that examines the extent of risk disclosure, aims to analyze and comprehend the evidence of risk disclosure. Furthermore, the study further contributes to the existing literature by analyzing the way firms have reacted and responded to new corporate governance laws and regulatory pressure. The reporting structure must reflect the new rules of corporate governance and other pressures that have taken place in recent years.

This gap in contemporary and past literature must be addressed in order to examine how companies respond to changing regulations; not only to test their compliance with the changes, but also to see whether they meet the needs of different kinds of users. For this, it is hoped that this research will provide an answer to the various queries raised regarding improving the disclosure of risk.

Solomon *et al.* (2000) stated that an increase in the risk disclosure would be regarded as evidence of, and exhibit compliance with new corporate governance laws. It is imperative to be up-to-date with the way attitude of firms have changed toward risk disclosure over time. There are various factors that impact the amount of information a company wishes to disclose, a few of which include advancement in technology, increasing global competition, new accounting standards among many others. The study of risk disclosure practices helps to understand whether the financial reporting community can view this as an area of best practices (Deumes, 2008). Some users might want to broaden their investigations and provide validity for these reporting practices. Furthermore, another benefit of this research is that it provides the investors with an objective method of evaluating the company's reporting practices. It is essential for investors to examine and comprehend the potential risks and how they are managed by the company. Risk disclosure also allows the investor to have an idea about the firm's future cash flows; its timing and amount. In addition, the increased disclosure would inevitably attract the users' attention. The results of the study can be of help to all types of users such as standard setters in setting the requirements and developing the framework of corporate risk disclosure.

Based on the first objective, this study refers to the body of knowledge on the subject of risk disclosure and all that it entails. First, based on the political cost theory this study argued that it is important to have more risk disclosure in annual reports to improve the credibility of public financial reporting in both imperfect and perfect markets. This study will enlarge on the role of disclosure in political cost theory (including disclosure of risk). This is necessary in an imperfect market to increase the market's efficiency. The study results will add to political cost theory to enable the creation of new policies for disclosure of risk that eventually lead to greater confidence in the capital market. Second, to the best of the author's knowledge, no previous studies have examined the trend of risk disclosure over 11 years in Malaysia. This study has contributed to knowledge in this field by enhancing the understanding of the idea of risk disclosure. This was enabled by the comprehensive review of the existing literature, classifying the types of risk and similar aspects of risk disclosure, and finally examining the development of policies and regulatory bodies in relation to risk disclosure in the Malaysian context. Third, this study enhanced understanding of the idea that meeting the demands of users with regard to yearly reports requires improvement in risk disclosure. The necessity to improve risk disclosure is not only a result of new regulations; other stakeholders have also demanded it in the wake of the Asian financial crisis of 1997. Fourth, this study also makes methodological contributions to fill the methodological gap by previous study which was done by Amran *et al.* (2009) in the Malaysian context; through studying the benefits of risk disclosure in the following aspects: financial, nonfinancial, and risk management framework and also the economic sign (monetary, non-monetary), type of measure (past, future), outlook (good, bad, neutral), type of disclosure (voluntary, mandatory). These categories are more suitable for the Malaysian context as they have been used in the emerging market by Oliveria *et al.* (2011a). Fifth, this study helps regulatory bodies to know how effective their regulations are in the development of risk disclosure. The results of this study show that mandatory risk disclosure is higher than voluntary risk disclosure in Malaysia, but it is still inadequate when compared to developed countries. Sixth, another contribution of this study is that it provides important evidence of the need to revise the current regulations and standards to enhance the quality of risk disclosure to meet international standards and policies.

This study adds to the contemporary literature by finding out the elements determining risk disclosure. Furthermore, this study will be beneficial to both the investors and the regulators as it helps them understand the types of information companies disclose in various sectors, and through finding the corporate governance factors of the firms disclosing such information. Based on the second objective, the study refers to the body of knowledge by examining risk disclosure in a number of ways. First, this study refers to agency theory and cultural theory which focus on the monitoring role of corporate governance best practices in companies. The results of the study indicate that conflict and the monitoring role increase the agency cost. Agency theory suggests that disclosure by managers (principals) can help reduce conflict cost (owner manager and owner debt-holder) by disclosing more information, increasing investors' and shareholders' confidence, and reducing agency cost. Therefore, this study aims to fill theoretical gaps of both agency theory and cultural theory as to the best knowledge of this researcher, no study has examined these theories in an emerging market. In the Malaysian context, the monitoring role of corporate governance helps companies decrease conflict, while increased risk disclosure and development help reduce agency cost and increase investor confidence in the capital market. In addition, this study supplies proof that there are essential factors that impact disclosure of risk in Malaysian companies. Also, to the best of this researcher's knowledge, no research has studied the relationship between the factors of corporate governance and risk disclosure in the Malaysian setting. This study signified to audit committee independence, independent non-executive directors, board size, ownership structure and race of chairman. Another significance of this study is related to the common discussion in previous research in relation to ownership structure, board size, independent non-executive directors, independence of audit committees, and race of chairman of the board.

This study contributes to other literature by analyzing the usefulness of disclosed information through empirical examination of the effect risk disclosure has on a firm's cost of equity capital. Only if the disclosed information in the annual report is actually useful to the investor will there - be a substantial relationship between the level of risk disclosure in annual report and the cost of equity. Other researches such as Botosan, (1997); Botosan and Blumlee, (2002); Hail, (2002); Chen *et al.* (2003) analyzed various types of disclosure such as investors' relation, corporate governance, environmental disclosure and financial gap disclosure with the particular focus of the study being on risk disclosure. Based on the third objective, this study refers to the link between risk disclosure and cost of equity capital. This contributes to the existing body of knowledge in a number of ways; first, this study adds to the capital need theory and signaling theory as the results suggested that market pressure plays a role in increasing the number of capital offers and drawing new investors. Furthermore, decreasing capital costs results in less asymmetry of information in the market, thus reducing potential investors' transaction costs, bid-ask spreads, and stock price volatility; therefore this study contributes to this theory to fill the gap in research on emerging markets because to the best knowledge of the researcher, there is no study that has examined it in emerging markets and no previous research has explored the relationship between risk disclosure level and cost of equity capital and its proxies in the context of Malaysia, which is an emerging and imperfect market also in addition to the development of different methods to estimate the cost of equity capital. Also, the results can support the widespread expectation mentioned in the previous literature that corporate disclosure leads to a lower cost of equity capital; the results can prove that risk disclosure is related to proxies of cost of equity capital (stock price volatility and stock return trading) for better estimation of cost of equity capital and its components.

In general, this study's main theoretical contribution was finding the linkage between political cost theory and agency theory, so the study results indicate that risk disclosure is a mechanism for conflict reduction and improving public financial reporting to lessen asymmetry in information. According to capital need theory and signaling theory the reduction of information asymmetry reduces cost of equity capital, leading to stock price volatility and more stock trading turnover (liquid market). The study results also contributed to cultural theory in the Malaysian setting. The findings of this study show that governmental controls are a much more influential factor in promoting risk disclosure when compared to the personalities of board members. Also, the findings of the study will be useful to the authorities concerned with setting accounting standards, setting who will be motivated to revise and improve accounting standards and traditional accounting practices. They can also standardize the rules of the contemporary competitive business environment, and help recognize risk disclosure as a mechanism to reduce information asymmetry between companies and the capital market. More disclosure of risk would facilitate regulations and reforms as well as the recommendations of specialized institutions. Moreover, this research's results have other possible effects for firms. Among these effects is that risk disclosure can be beneficial in the capital market in reducing equity capital costs and stock price volatility. In addition, it can help increase stock trading turnover. All of these factors encourage businesses to engage in good practices such as voluntary risk disclosure. Table 1.1 provides the summary of this research.

Table 1.1: Summary of this Research

Research Gap	RQs	Findings	Conclusion	Contribution	Implication
There is no previous study to find the practices and trend of risk disclosure over recent years in Malaysia	Do Malaysian non-financial companies have any positive growth on variation of risk disclosure over 11 years in their annual reports after Asian financial crisis 1997?	-The research results verified that there is a growing trend for greater disclosure of risk among Malaysian companies. -The findings show that mandatory disclosure was allotted the largest score followed by voluntary disclosure.	Indicate that companies disclose useful risk information in their annual reports but it is still insufficient.	-To the political cost theory that the narrative role of disclosure (including risk disclosure) is much more needed in an imperfect market to create a much more efficient market and confidence in the capital market. -Understanding of concept of risk disclosure and practices in Malaysia (rules, standards and development process) and various demands for information by investors. -Investigations allow regulatory bodies to understand the effectiveness of their regulations on risk disclosure development while this study indicates that mandatory risk disclosure reflects the level of risk disclosure but it is still insufficient compared to developed countries. -Developing a methodological approach and examining risk disclosure.	-To provide valuable proof of the need to revisit the current regulations and standards to improve the quality of risk disclosure and to comply with international accounting policy. -More attention on voluntary risk disclosure by companies.

Research Gap	RQs	Findings	Conclusion	Contribution	Implication
Need to examine corporate governance factors on risk disclosure due to mixed and inconclusive results of previous researches and no previous study in the Malaysian context.	Does the level of risk disclosure have an association with corporate governance factors such as ownership structure, board size, independent non-executive directors, audit committee independence, and race of chairman of the board from the years 2001-2011 in Malaysian non-financial companies?	Board size (positive and significant) independent non-executive directors (positive ad significant) audit committee independence (positive and significant) ownership structure (positive and insignificant), race of chairman (positive and insignificant).	The main essential factors that affect risk disclosure level are: board size, the number of independent non-executive directors on the board, and the audit committee independent.	-To contribute to agency theory and cultural theory which focus on monitoring role of best practices of corporate governance in the companies. -The evidence of underlying factors that could affect risk disclosure in Malaysian firms' annual reports. -The prevalent doubt in literature on the notion that board size, independent non-executive directors and audit committee independent affect the level of risk disclosure has been supported.	Need to investigate other corporate governance factors to highlight best practice of code of corporate governance in order to improve risk disclosure and risk transparency.

Research Gap	RQs	Findings	Conclusion	Contribution	Implication
Limited study and inconclusive results on investigating risk disclosure practices on the cost of equity capital and market reaction. No previous study in the Malaysian context.	Does the risk disclosure practice affect the cost of equity capital from the years 2001-2011 in Malaysian non-financial companies?	There is a significant negative relationship between the risk disclosure and the cost of equity capital, significant and negative with stock price volatility, and significant and positive relationship with stock trading turnover.	Significant relationship between risk disclosure and cost of equity capital and its proxies in an imperfect market.	-Contribute to capital need theory and signaling theory. -Development of using different methods to estimate the cost of equity capital.	Policymakers should ensure that any new standards will help improve the corporate disclosure to enable investors to make informed decisions based on information and after careful consideration of costs and benefits related to such risk disclosures.

1.8 Scope of the Study

Both content and empirical analyses were used in this study. Content analysis explained the subject matter being investigated; and includes characteristics of organizations, people and objects (Zikmund *et al.,* 2000), hence, content analysis is used to find out the presence of certain texts or particular concepts found in a text. The empirical method includes observation and experiments that will assist in the final analysis of the subject at hand. Following content and empirical analyses, this study provides the content analysis of risk disclosure investigation of the trend and growth of risk disclosure with keeping in line of regulation development for the period of 2001-2011. Subsequently, it empirically examined the relationship between corporate governance and the level of risk disclosure. Finally, it provides the empirical relationship of risk disclosure on the cost of equity capital and its proxies. To achieve the study objectives, this research was conducted in non-financial listed companies of Bursa Malaysia for the years 2001 to 2011. The years 1998 to 2011 provided the data required for this research to construct firm-year observation for the period from 2001 to 2011.

1.9 Outline of the Thesis

There are six chapters in this thesis. Chapter 1 discusses the research problem, research objectives along with the research questions, and the significance of the research. Chapter 2 provides the review of risk disclosure in Malaysia and risk disclosure concept. Chapter 3 focuses on the literature review and hypotheses development while chapter 4 discusses the research methodology in connection with the testing of the study hypotheses. Chapter 5 and chapter 6 present the results and discuss the findings, contributions and implementation of practices and theories of the study. This is followed by description of the limitations of the study and possible avenues for further research.

1.10 Conclusion

This chapter explained the issues raised in the study and their significance and specified the three research objectives. First, this study evaluated the content analysis for risk disclosure investigation to determine the trend and growth of risk disclosure and keeping in line with the regulation development for the period from 2001-2011. Second, it evaluated the empirical examination of the relationship between corporate governance and the level of risk disclosure. Finally, it evaluated the empirical relationship of risk disclosure and the cost of equity capital and its proxies. In line with the study objectives, this research was carried out in non-financial listed companies of Bursa Malaysia covering the period from 2001 to 2011.

1.11 Terminologies

Specific terminologies used in this study are defined as follows:

•Risk disclosure: Risk disclosure refers to information which firms disclose about their own risk exposure and semantic properties of the information disclosed, which include economic signs (monetary and non-monetary), type of measure (past and future), outlook (good, bad, and neutral), and type of disclosure (voluntary and mandatory) (Oliveira *et al.*, 2011a). Firms try to gratify accounting information users' needs by disclosing more information about different risks being faced and the sustainability of their operations(Elzahar and Hussainey, 2012). The availability of this information enables interested parties to achieve better assessments of current and future risks, for the optimization of their revenues through balanced portfolio diversification (Abraham and Cox, 2007). Risk disclosure assists investors in their investment decision-making according to their evaluation of disclosed information that allows them to weigh various risk levels before making decisions based on expected return and risk considerations (Cabedo and Tirado, 2004). Moreover, risk disclosure will lead to a better risk management, as well as improvement of accountability for stewardship, investor protection, and the usefulness of financial reporting (ICAEW, 1997).

•Corporate Governance: The total structure of rules and practices followed by a Board of Directors to ensure that the company's relationship with its various stakeholders (financiers, customers, management, employees, government, and the community) is accountable, fair, and transparent.

•Information asymmetry: This is a situation where there is imperfect knowledge. In particular it occurs when one party has different information to another. It means that information asymmetry is the gap information between corporate governance (insider) and investors (Aboody and Lev, 2000). This indicates that when information asymmetry between managers and investors increases, investors claim more cost of capital because of associated risk (Lambert *et al.,* 2011).

•Cost of equity capital: Cost of equity is in financial theory, the return that stockholders require for a company. The shareholders can rightly make a claim on the value of the company following any share issue, with such claim repaid after debt. As such, shareholders enjoy the double benefits of a dividend and an increase in their share value (Shi and Kim, 2007).

•Stock price volatility: Stock price volatility refers to the potential for a given stock to experience a drastic decrease or increase in value within a predetermined period of time. Investors evaluate the volatility of stock before making a decision to purchase a new stock offering, buy additional shares of a stock already in their portfolio, or sell stock currently in the possession of the investor. The idea behind understanding stock volatility is to arrange investments so that a maximum return with minimal opportunities for loss is achieved (Zhang and Ding, 2006). In addition, price volatility is the result of differences among traders, arising to some degree from information asymmetry. In the same way, because the volatility of stock price is influenced by several factors (size, volume of trading, the firm's systematic risk beta and the type of investors attracted to the firm) (Bushee and Noe, 2000; Glosten and Milgrom, 1985; Zhang and Ding, 2006).

•Stock trading turnover: It refers to the quantum of shares, bonds or contracts traded in a particular period for a security or a whole exchange. Trading volume volatility can be affected by investor reaction in the market or by any activity from the firm to the market. The volume of trade is a proxy that measures the shares liquidity by convincing willing investors to buy/sell. Trading volumes decline when the level of information asymmetry is high because investors are inclined to hold back in such a situation (Zhang and Ding, 2006).

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