

Disclosure practices and profitability of commercial banks in Ethiopia

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Abstract

The objective of this study is to determine the effect of profitability on disclosure practices in the case of Ethiopian commercial banks. The annual reports of selected commercial banks were the sources of data. The proxy used for financial performance is the return on asset. The disclosure level of sampled banks is measured by the ratio of disclosure score to maximum total obtainable score. Content analysis was applied to determine the level disclosure using un-weighted checklist. Correlation and regression analyses were made to determine the relation between disclosure practices and profitability. The result indicates that the profitability of banks' measured by return on asset positively affects the level of disclosure of Ethiopian commercial banks. Bank size and board size have no significant relation to the level of disclosure of Ethiopian banks.

Keywords: Disclosure, Profitability, Corporate Governance

1. Introduction

In corporate world information plays an important role and benefits companies in many respects. In conjunction, disclosure of corporate information has gained increased attention. This is due to globalization and integration of capital markets, greater mobility of monetary and actual goods, tougher competition, new dominating industries, and developments in information technology and the internet(1). Stakeholders are concerned with a firm's long-term survival as a way to preserve the value of their relationships. Accordingly, stakeholder's information needs reflect the dimensions of organizational performance in which they are interested and encompass both financial and non-financial performance measures (2).

Information provided by firms includes financial and non-financial information. In conjunction, (3)defined financial disclosure as a deliberate release of financial information, whether numerical or qualitative, required or voluntary or via formal or informal channels. This type of information is essential for investors to efficiently allocate scarce resources and assess investment options. But, financial information disclosure is not sufficient for decisions by firms' stakeholders. As a result, disclosure of non-financial information has got attention due to inadequacy of traditional financial information reporting to fulfil the need of stakeholders in assessing the organizations. Mohammad *et al.* (2014) stated that a non financial information disclosure is qualitative information in the companies' reports excluding financial statements and related footnotes.

To protect shareholders rights disclosure standards and transparency are the twin cornerstones. Only through full and complete disclosure and transparent management practices can shareholders feel confident that the firm which they have given their funds is being operated with their best interests in mind. Therefore, timely and accurate disclosure of information regarding the governance of the company is an important part of corporate governance and improves common understanding of the structure, activities and policies of the organization(4). The main objective of this study was

to determine whether profitability affects the level of voluntary corporate disclosure in case of Ethiopian commercial banks.

2. Literature Review and Hypothesis

The lack of transparency and disclosure was often considered as one of the major causes of the latest corporate scandals and governance failures, adversely affecting public confidence in the reliability of corporate and financial reporting, too (5).The rationale of disclosure by firms was explained by various theories: agency, stakeholder, legitimacy and political economy. Though different arguments, all theories agree that companies release information mostly for user groups such as shareholders, creditors, financial analysis and security consultants who find this information useful for their own sake(6). (7)Noted that corporate governance disclosure presents an excellent opportunity to apply agency theory, in the sense that managers who have better access to a firm's private information can make credible and reliable communication to the market to optimize the value of the firm. Also, agency theory suggests corporate governance disclosure may serve as a monitoring mechanism. In the real business world where the market is not perfectly efficient, managers use financial disclosure policy to balance the decisions they make and communicate to the outside shareholders. True agency costs are a consequence of information asymmetry and arise when investors undervalue the firm due to insufficient information. So increased transparency and disclosure shows the true value and makes investors more willing to invest(8). In conjunction, voluntary disclosures result in increased transparency and decreased asymmetry. To this end, (9) noted that the aim of voluntary disclosures is to inform the public more about the company. In turn, the management hopes that the stakeholders of the company will respond favorably to the company.

2.1. Factors Affecting Corporate Disclosure

Nothing the value of corporate disclosure, it can be affected by numerous factors encompassing the economy, capital

markets, accounting and regulatory framework, enforcement mechanisms, and culture (6). In the same vein, (10) noted that market forces, cost of disclosure, organizational factors, and corporate governance affect voluntary disclosure. Taking into account the capital market forces (11) argue there is a positive relationship between disclosing information to investors and stock prices. This is due to the fact that the corporations are managing the expectation of its investors and avoiding surprises and volatility. When it comes to labor market forces, managers will tend to disclose information that increases their reputation as good managers with anticipations of increase in their remuneration. In conjunction, firms also tend to delay disclosing bad news, but immediately disclose good news (10). Another factor is the cost of disclosure. Firms must bear the direct cost of disclosing the information to the public and those costs are not negligible as costs of preparation and analysis of the financial statements. Besides, revealing sensitive information to the public decreases firm's competitive edge since their competitors can glean more information on the inner workings of the corporation (12). Also, firms bear legal costs related to the non-disclosure of information in the forms of legal penalties and the cost to restate its publicly disclosed information to reflect this new information. From an economical perspective, managers will only disclose information if the advantages of such disclosure exceed the cost of disclosing the information. Organizational factors like the culture of the corporation, the strategy of the company and the internal politics of the firm are the main factors within the corporation that determine the level of voluntary disclosure (3). Even the personality of the person in charge of disclosure has influence on the level of disclosure of the corporation. To this end, (3) note that a more conservative person will have a ritualistic approach to disclosure while a more dynamic person will have an opportunistic approach to disclosure. Another factor is corporate governance of firms. In this regard, Donnelly & Mulcahy (2008) state that voluntary disclosure increases with the number of non executive directors on the board. Also, higher block-holder ownership is significantly related to an increased degree of voluntary disclosure(13). Conversely, if the dominant group of shareholders is composed of insiders, the level of disclosure will be lower. Case in point, Juhmani (2013) report that outside ownership is positively associated with voluntary disclosure and the "insider" or family ownership is negatively associated with voluntary disclosure. Furthermore, (14) found that the existence of an audit committee, foreign ownership, institutional ownership, firm size and leverage, have a significant positive relationship to the level of voluntary disclosures. In addition, professionals, such as accountants, influence the level of voluntary disclosure since they are often called upon to interpret certain disclosure rules and their advice has the effect of normalizing the application of disclosure rules (3).

2.2. Profitability and Corporate Disclosure

There is a general proposition that a company's willingness to disclose information is positively related to its profitability (15). One motive for this can be derived from agency theory. It is suggested that managers of profitable companies disclose extensive information in order to show and explain to shareholders that they are acting in their best interests and justify their compensation packages. In the same vein,

profitable companies are considered to be in good condition and have incentives to distinguish themselves from less profitable companies, in order to raise capital on the best available terms. Therefore, they voluntarily tend to disclose more information than less-profitable companies (16). In conjunction, (17) state that companies with higher performance are expected to comply better with the national corporate governance codes or they tend to disclose more voluntary information. Contrasting to any forms of relationship between disclosure and profitability, there may not be a significant relationship between profitability and disclosure(18), in this study, profitability was measured by return on asset to test the following specific hypothesis.

H₀: Profitability does not affect the voluntary corporate disclosure level of Ethiopian commercial banks.

H₁: Profitability affects the voluntary corporate disclosure level of Ethiopian commercial banks

2.3. Board Size and Corporate Disclosure

A board made of maximum seven or eight people is considered a small one and can help improve performance, while a board that exceeds seven or eight people is less likely to function effectively. Small boards are considered faster in information processing, more effective in monitoring the CEO and are tougher for the CEO or the chairman to manipulate(20). The empirical results are mixed about the relationship between board size and corporate governance disclosure. There is an argument that postulates a positive association. Accordingly, there were also empirical evidences suggesting a positive relation. To this end, (21) reported that firms with large board size are more likely to voluntarily disclose more information in their annual reports and websites. On the other hand, there is also another argument with a stand that members of large boards are more likely to be less motivated to participate in strategic decision-making (i.e. the decision to increase voluntary disclosure). As a result, a negative association between board size and disclosure would be expected(22). There were also studies which did not find any association between board size and disclosure(23), In conclusion, there is no preponderance of theory or empirical evidence to suggest a unique relation between board size and levels of voluntary disclosure.

2.4. Firm Size and Voluntary Disclosure

Big companies normally have also a large number of stakeholders unlike the small-sized companies and Companies with a large number of stakeholders will have a number of demands for information (24). There is a strong assumption and empirically tested relationship that claims there is a strong association between firm size and corporate governance disclosure. Brammer & Pavelin (2008) investigated that the larger the firm, the more likely they will make voluntary disclosures. There are reasons suggested for better disclosure of larger firms. For instance, managers of larger companies are more likely to realize the possible benefits of better disclosure and small companies are more likely to feel that full disclosure of information could endanger their competitive position(25). Also, larger firms have higher compliance to national corporate governance standards (17). There is a general agreement that a positive relationship between the size of a firm and its extent of

disclosure (16). In this study, a total asset was used as a proxy of bank size.

3. Research Methodology

This part covers target population, data, measurement of governance disclosure index and the regression method.

3.1. Target Population

The financial system of Ethiopia includes NBE with an aim to regulate the finance industry. The population of the study consists of 19 banks operating in Ethiopia three of which are state owned and the remaining sixteen are private banks. Two criteria were applied to fix the target population for this study. First, the bank should undertake commercial banking activities. To this end, one bank is excluded from the target population of study. This bank is the development bank of Ethiopia. It is a specialized financial institution established to promote the national development agenda through development finance. Secondly, a commercial bank should operate and issued its annual report for the year 2013/2014. Based on this criterion three more banks, are not considered in this study. Therefore, this study is based on data from 15 commercial banks in Ethiopia.

3.2. Data and Sources

The necessary data were collected from the annual reports of commercial banks in Ethiopia. The data for the level disclosure of banks is obtained by scoring bank’s disclosure practice through annual reports with a checklist developed for this purpose.

3.3. Measurement of Disclosure Level

A comprehensive list of voluntary corporate disclosure items was prepared for scoring the disclosure of each item in the annual reports of the commercial banks. The choice of disclosure items was guided by Organization for Economic Cooperation and Development (OECD) recommendation, Standard and Poor’s transparency and disclosure items and previous studies used similar methods. A similar approach was used by (5). The list includes both financial and non-financial items that are relevant to investors and other stakeholders. Accordingly, 53 items were considered. An un-weighted approach is followed to develop the voluntary corporate disclosure index. This approach is most appropriate when no importance is given to any specific user groups(5). After establishing the disclosure list, a scoring sheet was developed to assess the extent of corporate disclosure by banks. In doing so, if a bank disclosed information on the item of included in the list, it received a score of 1, and 0 if it is not disclosed. Such approach is supported by most prior studies aimed to develop such an index of disclosure, unlike weighted scores, which were rarely used before (14). The method of computing the corporate governance disclosure index for each bank can be expressed as follows:

$$DI = \sum_{j=1} dj/n$$

DI =voluntary corporate disclosures index;
 dj=1 if the jth item is disclosed otherwise 0; and
 n =the maximum score a bank can obtain.

3.4. Regression Model

A multiple regression analysis with Ordinary Least Squares (OLS) estimation method was applied. The regression equation developed empirically tests the relationship between the dependent variable, corporate governance disclosure and the independent variable ROA. In addition, board size and bank size were included in the regression as control variables. The regression technique used to test H₁ is as follows:

$$DI = a + \beta_1 ROA + \beta_2 BZ + \beta_3 TA + e$$

The variables that were used in the analysis are as follows:

Dependent Variable: DI = Corporate Governance disclosure index of each bank.

Independent Variable: ROA = Net profit to total Assets.

Control variable: BZ: Board size measured by the total number of directors Bank Size = Log of total assets of the firm.

e = the error term

4. Results and Discussion

Descriptive, correlation and regression results are presented as below.

4.1. Descriptive Statistics

The most commonly used measures of central tendencies are mean, mode and median. The mean is the most important measure of central tendency. The descriptive statistics used in this study consist of mean, maximum, minimum and standard deviation. They are useful to make general observations about the data collected.

Table 1: Descriptive statistics

| Variables | Mean | Max | Min | Std. Dev |
|-----------|-------|-------|-------|----------|
| DI | .55 | .633 | .517 | .0295468 |
| ROA | .027 | .047 | .012 | .0077793 |
| BZ | 9.4 | 12 | 7 | 1.764734 |
| BS | 22.93 | 26.21 | 21.76 | 1.134591 |

The results from the corporate governance disclosure index indicate (DI) the maximum score was by a bank was 63% and the minimum score was 52% with a standard deviation of .0295468. So the banks were narrowly distributed with regard to voluntary corporate disclosure. The mean percentage return on the asset as net profit to total assets was 2.7% with a standard deviation of 0.0077793. The mean of board size was 9.4 with standard deviation is 1.764734. Also, the mean of the bank size as logarithm of total asset was 22.93 with a standard deviation of 1.134591.

4.2. Correlation Matrix

The purpose of co-relation analysis was to draw conclusions as to the relationships between variables. Pearson correlation was used to establish whether there were statistically significant correlations between governance disclosure, return on asset, board size and bank size.

Table 2: Correlations Result

| | | | | |
|-----|---------------------|--------------------|---------------------|-----------|
| | DI | ROA | BZ | BS |
| DI | 1 | | | |
| ROA | 0.84 (.0001)* | 1 | | |
| BZ | -0.1598 (0.5694) | 0.0837 (0.7669) | 1 | |
| BS | -0.0257 (0.9274) | 0.100 (0.7222) | -0.1534 (0.5851) | 1 |

*Significant at 1%

From the above table it can be observed that the correlation between the dependent and independent variable was significant. The result indicates that voluntary corporate disclosure is positively correlated with the return on asset at the 1% level of significance. The other variables were not significantly correlated with corporate governance disclosure, even at 10% significance level.

4.4. Regression Results

Table 3: Regression Results

| Variables | Coefficient | Standard error | t values | Significance |
|-----------|-------------|----------------|----------|--------------|
| ROA | 3.335849 | .5376444 | 6.20 | 0.000* |
| BZ | -.0042996 | .0023864 | 1.80 | 0.099 |
| BS | .0039893 | .0037174 | 1.07 | 0.306 |
| Cons | .5916634 | .0909687 | 6.50 | 0.000 |

* P<0.01, two-tailed
 R square = 0.7840
 Adjusted R square= 0.7251
 F Value =13.31
 F significance =0.0006

Table 4 depicts the effects of profitability, board size and bank size on the level of voluntary corporate disclosure (DI). The results indicate an R-square of 0.7840, and an F value of 13.31, which is significant at the 0.01 level. Both of these values suggest that a significant percentage of the variation in voluntary corporate disclosure (DI) can be explained by the variations in the independent variable ROA. If the independent variable ROA is one unit increased then the situation in the dependent variable (voluntary corporate disclosure) is increased by 3.335849 with SE = .5376444, Beta t value = 6.20 and significant at the 1%. The result suggests that banks with a higher percentage of profitability were associated with higher corporate governance disclosure. This result is similar to that of(6). Besides, board size as well as bank size had no significant effect at the 5% level of significance.

4.4.Assumptions

1. Normality

In OLS regression the normality of residuals should be checked. If residuals do not follow a ‘normal’ pattern all test statistics are not valid. Then, it would become mandatory to check for omitted variables, model specification, linearity and functional forms. In conjunction, the normality of residuals was checked by a non-graphical test, Shapiro-Wilk test for normality. The p-value of Shapiro-Wilk test was 0.42232 which was sufficiently above cut-off value 0.05, it is concluded that residuals are normally distributed.

2. Multicollinearity

This test is conducted to avoid bias in the process of conclusions making regarding the partial test of each independent variable relatively to the dependent variable. Multicollinearity test was conducted by calculating the Variance Inflation Factor (VIF) of each independent variable. As a rule of thumb, a variable whose VIF values are greater than 10 or a tolerance value lower than 0.1 is suspected of multi-collinearity problem. However, the Variance Inflation

Factor (VIF) for variables were below 10 implying there was no Multicollinearity problems.

3. Heteroscedasticity

Heteroscedasticity is residual variance that is not constant in the regression model, so the accuracy of the prediction results becomes doubtful. Good model is a Homoscedasticity model. Breusch-Pagan test for Heteroscedasticity was made to evaluate the presence of Heteroscedasticity in the model. As per this test if the null hypothesis is rejected then the assumption of Homoscedasticity is violated. The p-value of this test was 0.6679 higher than any conventional significance level, which implies that the OLS assumption of Homoscedasticity was not violated.

5. Implication

This study explores the relation between profitability and in disclosure practice of commercial banks in Ethiopian. Based on the result, the null hypothesis was rejected. In other words, profitability measured by return on asset had a statistically significant positive influence on the level of disclosure practice of Ethiopian commercial banks. The finding adds to the existing literature by ascertaining the positive influence of profitability on corporate disclosure practice. However, the result is only based on Ethiopian banking industry, and hence there may be limitations in extending to other countries. Also, note that this study used data derived from one year. Maybe a panel data analysis over several years could change the finding. Future studies may consider disclosure channels other than the annual report.

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