CHAPTER FIVE

Impact of Corporate Governance Characteristics on Forward-Looking Disclosures in Integrated Reports of Listed Companies in Sri Lanka

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Abstract

The purpose of this paper is to identify the nature and extent of forward-looking disclosures (FLD) in integrated reporting (IR) and the impact of corporate governance characteristics on forward-looking disclosures in integrated reports of listed companies in Sri Lanka. The study used structured content analysis based on a forward-looking disclosure index developed on the International Integrated Reporting Framework (IIRF) and a quantitative research approach. Descriptive statistics, Correlation, and Panel Data regression were performed to achieve the research objectives. Findings revealed that the companies provide less forward-looking information concerning the content elements of IIRF. However, these forward-looking disclosures have shown an increasing trend over time. This study further revealed that corporate governance has a significant relationship with forward-looking disclosures in integrated reports. Additionally, it is identified that board composition and board expertise have positively impacted the extent of forward-looking disclosures in these companies while board size, audit committee size, independence of the audit committee, and audit committee expertise were negatively associated with forward-looking disclosure level. Due to the identified dearth of research on forward-looking disclosures in integrated reports in general and particularly in developing countries like Sri Lanka, the findings would provide insights for policymakers and practitioners concerning forward-looking disclosure practices in companies that prepare integrated reports and the need to establish specific guidelines in this respect.

Keywords: *Corporate Governance Characteristics, Forward-Looking Disclosures Index, International Integrated Reporting Framework, Panel Data Regression.*

1. Introduction

The demand of the stakeholders in the last couple of decades has increased considerably for information on the environment, social, non–financial, and governance. This information, like financial information, was critical. However, the weaknesses in financial reporting and sustainability reporting systems have led to a need for a better way to report corporations. This led primarily to developing integrated reporting as a new corporate reporting dimension. To improve management efficiency and decision-making on investments, integrated reporting is an attempt to make corporate disclosures more effective. Integrated reporting is a more efficient and interconnected corporate reporting methodology that focuses on improving the quality of information available to financial capital providers.

Publicly traded corporations are expected to issue annual financial statements detailing an organization's financial position and corporate governance reports showing the extent of corporate governance practices (Garcia, 2013). Companies also voluntarily publish corporate governance, social and environmental reports as a form of non–financial disclosure of information to increase data transparency and accountability (Oliveira, 2010). Financial reporting, according to investors, attempts to convey relevant information that can aid decision-making. Companies give forward-looking information regarding their expectations, such as cash flows, revenue forecasts, and sales volume. It also includes information about non-financial projections, such as ambiguity in future business operations, evaluation, agency relationships, risk, analysis, and other pertinent information about the company (Aljifri & Hussainey, 2007). This type of data is advantageous since historical data can be used to predict future performance, but it cannot guarantee future outcomes. Therefore, investors must make informed decisions based on valuable future data. Disclosures and measurements based on present and future forecasts are more relevant to investment decision-making than disclosures based on historical metrics, which may be highly trustworthy but lack relevance due to their inability to provide insight into current or future cash flow assumptions. Companies with high-quality corporate governance procedures were more likely to disclose projected information, according to previous research (Wang, 2013); for example, they believe that high corporate governance in a company makes it more likely to provide revenue forecasts. Disclosing forward-looking information in a company's annual report results in more informative reports about future performance.

As a result, forward-looking information has become more relevant for all stakeholders, including future forecasted information on both financial and non–financial statements (Bravo, 2016). Despite companies that publish integrated reports, there is a study on the provision of forward-looking disclosures in integrated reports and forward-looking disclosure determinants that are dearth. Accordingly, Sri Lanka has experienced a rapid spread of integrated reporting. By 2018, the number of companies taking integrated reports grew from 32 to 85 in 2015 in Sri Lanka per the data derived from Colombo Stock Exchange. Although IR has been a compelling choice for Sri Lankan, early adopters, it has been a fashion choice for many late adopters. The researcher identified two main objectives to continue the study as follows.

- To determine the nature and extent of forward-looking disclosures in integrated reports published by listed companies in Sri Lanka.
- To identify the relationship between corporate governance characteristics and the level of forward-looking disclosures provided in integrated reports in listed companies in Sri Lanka.

In this context, this research discusses the essence and scope of forward-looking disclosures (FLD) in integrated reporting (IR) and the effect of providing such details of the corporate governance characteristics. Accordingly, this research was carried out by considering market capitalization in the 50 companies listed on the Colombo Stock Exchange (CSE), excluding financial sector companies such as diversified financials, banks, and insurance companies from 2011 to 2020.

2. Previous Literature

The agency cost theory provides the initial background for the association between corporate governance and the disclosure of forward-looking information. Separate ownership and control automatically create a problem between the principal and agent (Jensen, 1976). At the core of this problem is the issue of information asymmetry due to the privacy of the agent (manager) been higher than the principal (owner) information. The new accounting regulations only recommend minimum disclosure standards that are considered inadequate for efficient reporting decisions to invest. According to Jensen (1976), corporate governance structures, such as corporate boards, independent directors, and institutional investors encourage accountability. Corporate governance can encourage the creation of higher strategies for disclosure that allow managers to communicate the underlying business realities to outside investors. Companies may minimize the asymmetry in information between the principal and agent through more important disclosures such as forward-looking information. Because of its significance, several countries have started to drawing up corporate governance inside and outside corporate companies.

Signaling theory tends to overview the determinants of forward-looking disclosure. Spence (1973) initially proposed the signaling theory to explain workforce market uncertainty. In this theory, information disclosure can be viewed as a signal to capital markets to reduce information asymmetry, reduce financing costs, and increase corporate value. As a result, signaling theory advises that managers publish a significant amount of information in corporate reports to send specific signals to the reports' potential recipients (Elzahar et al, 2012).

Forward-Looking Disclosures

Non-financial and financial information disclosures in corporate annual reports have attracted the interest of many researchers in both developed and developing countries (Garanina & Dumey, 2017). In addition to the annual report, organizations disclose a variety of information to assist users in making decisions by providing them with valuable connected data that aid in anticipating the future performance of firms. The information in the annual reports of the company should be divided into two categories: forward-looking information and backward-looking information. The disclosure of backward-looking information is information about the company's historical results. On the other hand, forward-looking information refers to forecasted firm performance results such as expected revenues, earnings for the coming year, and anticipated cash flows for the coming year (Aljifri & Hussainey, 2007).

There is a strong possibility of voluntary FLD provision from companies with practical corporate governance activities (Hossain, 2005). In the annual reports of the United Arab Emirates, Aljifri & Hussainey (2007), who studied the determinants of FLD, found that profitability, debt ratio, audit committee size, business type, and firm size have a significant effect on FLD. Similarly, Abeywardana (2016) identified the size of the board, the proportion of independent non–executive directors, and the company's size as the determinants of the FLD. Further, Abed & Najjar (2014) justified that board size, board independence, board gender diversity, board experience, board meetings, audit committee size, audit committee independence, audit committee competence, and several audit committee meetings are variables in corporate governance that significantly affect the provision in FLD.

Integrated Reporting and Forward-Looking Disclosure

Integrated reporting (IR) requires a new, creative approach to existing practices in corporate reporting. It is now gradually used in several nations according to the International Integrated Reporting Framework (IIRF) issued by the International Reporting Council (IIRC). This has contributed to creating detailed reports to tackle the problem of having information in various reporting types (Gray, 2010). According to IIRC (2013), the integrated report, the output of IR, offers a concise communication on how the policy, governance, success, and prospects of an entity contribute to value creation in the short, medium, and long term, in the sense of its external setting. Financial, manufactured, intellectual, human, social and relationship, and natural capital are the six forms of capital identified by the IIRC framework. The fundamental goal of the integrated report is to increase accountability for those capitals and provide a better understanding of their inter-relatedness and trade-offs (Hossain, 2005).

An integrated report also highlights expected changes over time and provides information about the organization's expectations regarding the external environment in the short, medium, and long term, as well as how it may affect the organization and how it is currently equipped to respond to critical challenges and uncertainties (IIRC, 2013). In essence, the integrated report outlines the short, medium, and long-term possibilities and challenges that may arise and their potential impact on the organization's financial and non-financial performance. Academic scholars have made claims about the benefits of disclosing forward-looking information. First, releasing forward-looking information reduces information asymmetry, which occurs when some entities have confidential information about a company that investors and other stakeholders do not have access to (Uyar & Karamahmutoglu, 2012). Forward-looking statements on future operations, plans, strategies, and financial goals are also helpful in assessing predicted cash flows and a company's future value. Although backward-looking data is insufficient for investors to foresee potential possibilities and hazards forward-looking information is critical in making investment decisions.

3. Methodology

The quantitative approach has been followed since the study explores the relationship between the characteristics of the selected corporate governance and the forward-looking disclosure (FLD) level. The total population of the research was 287 listed companies on Colombo Stock Exchange under 19 GICS industry groups as of 30th September, 2021. The population and sample of the study selected 50 listed companies out of 287 listed companies on Colombo Stock Exchange (CSE) considering market capitalization excluding the financial sector (diversified financials, bank, and insurance companies) that have been selected to prepare consolidated reports for ten consecutive years from 2010 to 2020. The financial sector was excluded because they had a unique corporate governance framework than the other companies. Further, diversified holdings were also excluded to avoid duplicating the same firm as an individually listed firm under the holding company. The diversified holding firms are simply head offices with no business operations. Simultaneously, secondary data was used in the research. All of the research variables' data was included in the companies' management reports and annual reports.

Table 1: Operationalization

Variable	Measurement
FLDI	The proportion of disclosed items to the total items in the index
BSIZE	Total number of directors on the Board
BINDP	Non-executive directors / Total number of directors on the Board
BEXP	Board expertise / Total number of directors
AUDCSIZE	No. of audit committee members
INDPAC	Non-executive directors / Total number of directors in the audit committee
AUDCEXP	Board expertise / Total number of directors in the audit committee
FSIZE	The natural logarithm of total assets
LEV	Total Liabilities / Total Assets

Source: Constructed by Authors by Reviewing Literature.

An FLD index was adopted to identify the nature and magnitude of FLDs in sample companies' integrated reports. Accordingly, the FLD index includes six IIRF (International Integrated Reporting Framework) – Organizational Overview and External Environment (ORG), Governance (GOV), Business Model (BUS), Risks and Opportunities (RISK), Strategy and Resource Allocation (STR), and Performance (PERF), ignoring two elements because 'Outlook' aspects represent its existence future details and the 'Basis of Preparation' are still historical data. Accordingly, twenty-five knowledge categories were listed within those six areas. Under each group, the integrated reports of sample companies were evaluated by counting the relevant sentences on FLD. After that, an FLD score was determined for each content item of the index for sample companies for the ten-year duration based on the sentence count's natural logarithm.

Analysis Tools

The research data was analyzed using quantitative techniques such as descriptive statistics, correlation analyses, and panel data regression using the Ordinary Least Square method. While analyzing the study's first objective (assessing the nature and extent of FLD), it will evaluate descriptive statistics, including central tendency and dispersion measurements. Correlation and panel data regression analyzes (including the Hausman test for identification of random and fixed effects) supported to achieve of the second objective (examining the relationship between corporate governance characteristics and the level of FLD).

4. Results & Discussion

Descriptive Statistics of Forward-Looking Disclosure Criteria

The descriptive statistics of FLD presented in Table 2 indicate that the mean score of all content elements is relatively low, indicating a low level of forward-looking disclosure level in integrated reports. Of the six content elements of the FLD index, the highest level of FLD was witnessed under ‘Organizational overview and external environment (ORG)’. However, the ‘Organizational overview and external environment (ORG)’ content element’s standard deviation was the highest, indicating a greater degree of variability of FLD scores of individual companies. This was followed by content elements – ‘Governance’, ‘Business Model’, ‘Risk and Opportunities’, ‘strategy and resource allocation’, and ‘performance ‘in terms of the mean score. The highest standard deviation was reported for ‘business model’, which indicated a higher degree of variability of individual company scores. The mean score of FLD of the ‘strategy and resource allocation’ was the lowest among the six content elements but with a low standard deviation, which indicated that all companies have not provided much FLD in this respect. The peculiar characteristic is that in the case of the ‘business model’ content element, the reported minimum score is 0, which indicated that some companies have not provided any business model forward-looking disclosures.

Table 2: Descriptive Statistics of FLD

FLD Disclosure Criteria	Obs.	Mean	Std. Dev.	Min.	Max.
Organizational Overview and External Environment (ORG)	500	2.442	0.171	1.946	2.639
Governance (GOV)	500	2.086	0.093	1.792	2.197
Business Model (BUS)	500	1.358	0.451	0.000	2.197
Risks and Opportunities (RISK)	500	1.599	0.262	0.693	1.792
Strategy and Resource Allocation (STR)	500	1.272	0.217	0.693	1.386
Performance (PERF)	500	1.931	0.112	0.693	1.945
Forward-Looking Disclosure Index (FLDI)	500	1.193	0.056	-0.004	0.303

*See Appendix A for the sub-criteria for the main dimensions of FLDI included.

Source: Eviews Output.

Relationship between FLD and Corporate Governance Characteristics

The correlation analysis is used to identify the association between corporate governance and forward-looking disclosure level in integrated reports published by listed companies in Sri Lanka. As per the table below (Table 3) BINDP, BEXP, FSIZE, and LEV variables positively correlated with forward-looking disclosure level. However, BSIZE, AUDCSIZE, INDPAC, and AUDCEXP variables negatively correlated with forward-looking disclosure levels. The value of the Pearson correlation of BSIZE was -0.019 hence there is a low degree of a negative relationship between board size and forward-looking disclosure level in integrated reports. The value of the Pearson correlation of BINDP was 0.224 hence there was a low degree of a positive relationship between board composition and forward-looking disclosure level. The value of the Pearson correlation of BEXP was 0.319 hence there was a low degree of a positive relationship between board expertise and forward-looking disclosure level. The value of the Pearson correlation of AUDCSIZE, INDPAC, and AUDCEXP were -0.089, -0.227, and -0.096 respectively. Hence there was a low degree of a negative relationship between audit committee size, independence of audit committee, and audit committee expertise between forward-looking disclosure levels in integrated reports. In addition, the value of the Pearson correlation of FSIZE and LEV were 0.336 and 0.294. Hence there was a low degree of a positive relationship between firm size and leverage and forward-looking disclosure level in integrated reports of listed companies in Sri Lanka.

Table 3: Correlation Analysis

	FLDI	BSIZE	BINDP	BEXP	AUDSIZE	INDPAC	AUDCEXP	FSIZE	LEV
FLDI	1.00								
BSIZE	-0.02	1.00							
BINDP	0.22	0.11	1.00						
BEXP	0.32	0.19	0.19	1.00					
AUDSIZE	-0.09	0.33	0.27	-0.03	1.00				
INDPAC	-0.23	-0.24	0.13	-0.14	-0.08	1.00			
AUDCEXP	-0.09	0.02	0.21	0.02	0.18	0.22	1.00		
FSIZE	0.34	0.02	0.04	0.01	-0.08	-0.18	-0.19	1.00	
LEV	0.29	-0.21	-0.17	-0.12	-0.23	-0.12	-0.37	0.20	1.00

Source: Eviews Output.

The results of panel data regression analysis implied that there was a significant negative relationship between board size and forward-looking disclosure level. That means the higher the board size, the forward-looking disclosure level is lower in integrated reports published by listed companies. In addition to the above point, the results indicated significant positive relationship between board independence and forward-looking disclosure level. Meaning, the independence of the board is highly impacted by the level of forward-looking disclosure and the level is higher in integrated reports published by listed companies. Further, the analysis implied that there was a significant positive relationship between board expertise and forward-looking disclosure level. That means if the board has accounting and finance proficiency directors, the forward-looking disclosure level is higher in integrated reports published by listed companies.

Further, the results of panel data regression analysis revealed that there was a significant negative relationship between audit committee size, independence of audit committee and audit committee expertise, and forward-looking disclosure level in integrated reports published by listed companies in Sri Lanka. These corporate governance characteristics significantly impacted the forward-looking disclosure level. Nevertheless, many past research findings indicated a significant positive relationship between board committees and audit committees regarding the level of forward-looking disclosures. Mahir (2019) found that corporate governance characteristics -board size, board expertise, independence of audit committee, and audit committee meetings- have positively impacted the extent of FLDs in banking companies. Moreover, Samuel (2020) showed a statistically significant and positive relationship between the proportion of independent directors on a corporate board and firms' disclosure of forward-looking information. He suggested that including more independent directors on corporate boards could improve information disclosure and enhance transparency.

On the contradictory, Elzahar et al (2012), Uyar and Karamahmutoglu (2012), and Abed & Najjar (2014) failed to find a significant effect of board independence on the level of FLD. This insignificant association could result from the effectiveness of independent directors being dependent on the institutional systems and business cultures in which a company operates (Kakabadse et al., 2010).

Table 4: Panel Data Regression (Fixed Effect Model)

Variables	Coefficient	Probability Values
BSIZE	-0.2195*	0.02
BINDP	0.0199*	0.02
BEXP	0.0478*	0.00
AUDCSIZE	-0.0181*	0.00
INDPAC	-0.0232*	0.01
AUDCEXP	-0.0275*	0.00
FSIZE	0.0352*	0.00
LEV	0.0272*	0.01
CONSTANT	-0.5906*	0.00
Prob>chi^2	0.000	
R^2	0.86	
Observation	500	

*P<0.05 (Significant at the 95% confidence Level).

Source: Eviews Output.

5. Conclusion

This study examined the nature and extent of forward-looking disclosures reported by listed companies in Sri Lanka from 2011 to 2020. Simultaneously, this study also examined the extent of FLDs in integrated reports using a forward disclosure index developed based on prior literature on the subject. After that, the relationship between the corporate governance and the level of FLD in integrated reports was examined using correlation and panel data regression analyses. Accordingly, the corporate governance considered board size, board composition, board expertise, audit committee size, independence of the audit committee and audit committee expertise and firm size and leverage as the control variables respectively.

Consequently, this study found that most FLDs are limited and qualitative, and most disclosures relate to the ‘organizational overview and external environment (ORG)’ of these companies. On the other hand, the least amount of FLD is witnessed concerning the business model. Further, the FLD relating to ‘strategy and resource allocation was also limited. The study also found that the degree of FLD fluctuated significantly among the companies that produce integrated reports in this sector. In addition, the board composition (BINDP) and board expertise (BEXP) have a positive and significant effect on the degree of forward-looking disclosure level in integrated reports of listed companies in Sri Lanka. On the other hand, board size (BSIZE), audit committee size (AUDCSIZE), independence of the audit committee (INDPAC), and audit committee expertise (AUDCEXP) have a significant negative impact on the degree of forward-looking disclosure level in integrated reports. This indicates that some corporate governance characteristics play a significant role in the provision of FLD in integrated reports in developing context country’s listed companies like Sri Lanka.

After evaluating the findings, regarding the impact of corporate governance on forward-looking disclosures in integrated reports in listed companies in Sri Lanka, future implications could be derived. Accordingly, in the future studies, corporate governance characteristics can be extended further by assessing the relationship between corporate governance on forward-looking disclosures in integrated reports. Therefore, future studies should consider obtaining the views of investors on the adequacy of forward-looking disclosure information made available by firms and how that affects their investment decision-making. Using both primary and secondary data will contribute to and strengthen the empirical literature.

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