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Does Quality of Non-Financial Information Disclosure Influence Firms' Profitability in Malaysia?

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Abstract *The purpose of this study is to determine the level of quality of Non-Financial Information disclosure in Malaysia. Non-Financial Information disclosure in this study refers to Corporate Social Responsibility disclosure, Intellectual Capital disclosure, Risk Management disclosure and Corporate Governance disclosure. This study also aims to examine the influence of quality of Non-Financial Information on firm's profitability. It further identifies which Non Financial Information disclosure has the highest influence on firm's profitability. Data was collected from 100 selected annual reports of Public Listed Companies by using random sampling technique and was analyzed by using Multiple Linear Regression. Two ratios have been used to measure the firms' profitability. This study reveals mixed finding on the influence of Non-Financial and firms' profitability. The results show that Corporate Governance disclosure has the highest influence on firm's profitability. This study provides useful insight to the authorities on the level of quality of Non-Financial Information and this information enables them to focus on areas that need improvement. This study also gives a better understanding to the users of annual reports on the influence of Non-Financial Information disclosure on firm's profitability.*

Key words Non-Financial Information, Corporate Governance Disclosure, Corporate Social Responsibility Disclosure, Risk Management Disclosure, Intellectual Capital Disclosure

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1. Introduction

Information plays an important role in corporate world as it can benefit the companies in many ways (Katmun, 2012). The information provided includes financial and non-financial information (NFI). However, recent decades has witnessed the rise attention on NFI due to inadequacy of traditional financial information reporting to fulfill the need in assessing the organization value. Companies have moved from passive to active information disclosure, from strict to know compliance disclosure to right to know complete disclosure and they are aspiring to link corporate strategy with one comprehensive stream of nonfinancial and financial data (Maxwell, Smith and Brewster, 2010). According to Robb, Single, and Zarzeski, (2001), NFI disclosure is qualitative information in the companies' reports which exclude financial statements and related footnotes. For the purpose of this research, NFI refers to the information on Corporate Social Responsibility (CSR), Intellectual Capital (IC), Risk Management (RM) and Corporate Governance (CG). Not much research had been conducted previously to analyze the important of NFI as an investor decision-making despite advocate's arguments on that area (Webb, Cohen, Nath, Hoff and Wood, 2009). During the past two decades, there have been many ideas to improve business reporting, and nearly all of them focus on the importance of companies providing more NFI (Eccles, Robert, Serafein and Consulting, 2011). The objectives are to inspire transparent reporting standard, to promote corporate accountability and to build up good governance. However, currently, the NFI disclosure has been badly criticized as it failed to fulfill the expectation from stakeholders (Ping, 2012). Previous literatures researched and discussed the information disclosure on CSR, IC, RM and CG independently (Jamali, Safieddine and Rabbath, (2008); (Yi and Davey, 2010); Ismail and Rahman, 2013 and Mizuno (2010). Owing to the investors' needs, those areas should be combined to develop a model on quality of NFI as there is a gap of knowledge on the quality of NFI towards the firms' profitability. Furthermore, there is no widely acceptance guidelines to promote the quality of NFI around the world and the current status is highly variable (Yi and Davey, 2010). In this regards, this study intends to determine the quality level of NFI disclosure in Malaysia and to examine on how NFI will influence firm's profitability. In addition, this study also aims to identify which category of NFI disclosure has the highest influences on the firm's profitability.

2. Literature review

2.1. Corporate Social Responsibility Information

In recent years, companies were paying more attention to demonstrate their commitment to CSR by including it in the information provided to their stakeholders (Kotonen, 2009). Although some of the researchers name this disclosure as CSR reporting (Day and Woodward, 2009; and Khan, 2010), corporate social disclosure (Menassa, 2010), social and environment reporting (Guthrie, Cuganesan and Ward, 2006) and corporate social reporting (Amran and Siti-Nabiha, 2009), the fundamental was referring to the same ground which was to report the companies' CSR activities to the public. Researchers around the world studied their countries' CSR disclosure level to indicate the awareness of CSR practice. For example, Pratten and Mashat (2009) examined the CSR disclosure in Libya; Popa, Blidi and Bogdan (2009) examined CSR disclosure in Romania; and Shil and Paramanik (2009) examined CSR disclosure in Bangladesh. Evidences exist that investors sees social and environmental information as an important tool in making investment decisions and hence demand adequate disclosure of such information (Yekinni, 2008). Previous researchers found positive correlation between CSR disclosure towards financial performance such as Wibowo (2012) and Khaveh, Nikhashemi, Yousefi, and Haque (2012).

2.2. Intellectual Capital Information

There was growing agreement that inadequacy of information provided in the previous traditional financial report was insufficient to fulfill the stakeholders need and leads the company to be at the risk of insider trading thus affecting the investor's confidence; consequent of which firms subsequently disclose their information on IC (Rahim, Atan and Amrizah, 2011). Rapid emergence of information and communication technologies increased the momentum of IC in 1990s (Damarchi, Amiri and Rezvani, 2012). The IC information disclosure reflects the company performance whereby it encourages users' better decision making and evaluation on the company for preceding periods as well as reducing ambiguity (Azman and Kamaluddin, 2009) as economic value derives from production of goods and creation of IC. Previous studies concluded that IC information was able to reduce the risk of a potential investor in making a decision towards a firm's investment (Halim, 2013; An, Davey, and Eggleton, 2011 and Abeysekera, 2010). Empirical research in "non traditional" industries also consistently found that IC information adds value to financial information (Vafaei, Taylor and Ahmed, 2011). Research by Deep and Narwal, (2014) found that IC disclosure was significantly associated with firm's performance.

2.3. Risk Management Information

Debate on the importance of risk reporting commenced as early as 1998 when the Institute of Chartered Accountants in England and Wales (ICAEW) published a discussion paper entitled "Financial Reporting of Risk – Proposals for a statement of Business Risk. (Amran, Abdul Manaf and Che Haat, 2009). Previous study had investigated the level of risk management disclosure in Portuguese (Oliveira, Rodrigues and Craig, 2011), Malaysia (Amran, Abdul Manaf and Che Haat, 2009;Ismail and Rahman, 2013), Dutch and Germanic countries (Deumes and Knechel, 2008). Generally, those studies found that risk management disclosure level are too brief, vague and not sufficient for the stakeholders to make investment decision. This inadequacy problem in RM information disclosure had been recognized. There were studies to investigate the incentives for voluntary disclosure and disclosure quality (Htay, Rashid, Adnan and Meera, 2012). However, few studies were conducted in investigating the the quality of risk management disclosure (Oliveira *et al.*, 2011). Study by Ismail and Rahman, (2013) concluded that the overall score for RM disclosure among public listed companies in Malaysia is 53%, demonstrating that there are rooms for improvement on the level of risk disclosure.

2.4. Corporate Governance Information

Mccahery, Sautner and Starks, (2011) stated that CG is important for the institutional investors' investment decisions. Although past studies showed that there are links between CG and investment decisions, majority of them are only focus the studies on institutional investors such as Mizuno, (2010)'s study in Japan, and Gill, Sharma, Mand and Mathur, (2012)'s study in small business in India. Few researches have been conducted to determine the relationship between quality of CG disclosure and financial performance. Mixed results have been found from the previous research. Recent study (Abd. Hamid, Abdul Aziz, Dora and Said, 2012) showed that the quality of CG did not correlate with financial performance. The financial performance in their study was measure by ROA. In contrast, another study on CG disclosure and financial performance was conducted by Rouf (2012) on non-financial listed companies in Bangladesh. A total of 94 annual reports of selected listed companies was analyzed using Ordinary Least Square method of estimation. The results indicated that the quality of CG disclosure was positively correlated with the profitability measure by ROA.

2.5. Theoretical Framework

This study employs legitimacy theory, stakeholder theory and agency theory as a theoretical framework. The legitimacy theory presents two basic ideas whereby companies need to legitimize their activities and this legitimacy process provide benefit to the company (Hassan and Marston, 2010). Disclosing quality NFI is a way for company to legitimize their activities. The benefit from the legitimacy process is represented by firm's profitability. Legitimacy theory presumed that a corporation will act to ensure that its actions and activities were congruent with whom it believed has the necessary attributes to affect the corporation's image and, ultimately, existence (O'Donavan, 2000).

Another theory that supports the development of this study is stakeholder theory. Stakeholder theory has been pioneered by Ullman (1985) who introduced three models: pressure from stakeholders, the strategy of corporate response, and the level of economic performance. The first levels explains the company's reaction towards the demand from a broader base of stakeholder (Husillos and Alvarez, 2008; Sweeney and Coughlan (2008); Dincer (2011); (Van der Laan, 2009). The second level was consistent on the corporate response, which was producing quality NFI (Kent and Chan, 2009). The third levels referred to the economic performance that will determine the financial strength and weaknesses of the corporations (Elijido-ten, 2004; Van der Laan, 2009) and it was seen that higher level of profitability will be achieved through disclosing of NFI (Jamali *et al*., 2008).

Agency theory becomes a popular rationale for NFI disclosure since its emergence as an explanatory model for corporate reporting (Cheung and Mak, 2010). It is developed based on Adam Smith's classical school of thought. It viewed the firm as a nexus of contracts between various economic agents who act opportunistically within efficient markets (Reverte, 2008). In this theory the management acted as the agent of the corporation while the shareholders were the owner (principal) of the corporation. Shareholders are always expecting the agents to act in the interest of the principal. Unfortunately, in circumstances the agents may acted in their self-interest and falling short of congruence between the principal and agents. Mulili and Wong (2011) highlighted that there will be a conflict when the managers did not manage the corporations in the best interest of the owners. However, Gray, Owen and Adams (1996) offered the idea that managers used company's information to satisfy or manipulate influential stakeholders in order to gain their support which was required for survival. Mechanisms to observe managers, lessen information asymmetry and maximize shareholder's wealth are necessary in agency theory (Cormier, Ledoux and Magnan, 2011). In this study maximization of shareholders' explained the firms' profitability.

3. Methodology of research

Secondary data collection has been employed in this study whereby the unit of analysis is the annual report of the public listed company on the Bursa Malaysia. A total of 100 companies' annual report for the financial year ended 2012 were selected randomly. Financial year ended 2012 was selected as this is the latest annual report available in Bursa Malaysia website as at the date this study was conducted. Items that extracted from the annual report are CSR disclosure, IC disclosure, RM disclosure, CG disclosure, net profit before interest and tax, total assets, and total equity. The four categories of disclosure are presented in qualitative manner for example sentences and pictures. Thus, content analysis procedure has been used to convert the qualitative data to quantitative data. On the other hand, the information for net profit before interest and tax, total asset, and total equity is quantitative data and no conversion is required.

3.1. Measurement for Corporate Social Responsibility Disclosure

The quality of CSR disclosure was determined using a list of items in the disclosure index. This selection of the items was adopted from the study conducted by Ramly (2012) and Mohamad *et al.* (2010) which is based from Bursa Malaysia Listing Requirement and Malaysian Code of Corporate Governance. Items selected to be included in the list is relevant with the Malaysian perspective and has been classified into four indicators of CSRD that are: (1) employee relations; (2) environment; (3) community involvement; and (4) product. Every indicator has sub-item disclosures that are adjusted based on whether the items are disclosed. Furthermore, (Al-Tuwaijri, Christensen and Hughes, 2004) proposed that the process for measurement the quality of CSR disclosure can be achieved by using quantitative disclosure measures with denoted weights for different disclosure items. These are based on the perceived importance of each item to various user categories, which also marks the greatest weight of '3' for quantitative disclosures related to the four CSR indicators or categories. Marking the next highest weight of '2' for non-quantitative but specific information related to these indicators. Lastly, common qualitative disclosures receive the lowest weight of '1'. Firms that do not disclose any information for the given indicators receive a zero score. The highest score is 60 (3 X 20 items). The CSR score for the company is derived by calculating the ratio of actual sum of scores awarded to a company to the maximum score (60). This score was converted into a percentage form

3.2. Measurement for Intellectual Capital Disclosure

IC disclosure was measure using IC disclosure index adopted from Rahim *et al*., (2011). In their study they have listed 24 intellectual capital attributes across three categories: internal capital, external capital and human capital. In the current study human capital aspect has been withdrew to avoid overlapping as it already included in CSR index. Weighted disclosure index has been performed as per appendix B, whereby a score of three (3) was assigned if the disclosure item was in quantitative terms; a score of two (2) was assigned if the disclosure is non quantitative but specific; a score of one (1) was assigned if common disclosure was provided and a score of zero (0) for non-disclosure of IC information. The highest score is 27 (3 x 9 items). The IC score for the company is derived by calculating the ratio of actual sum of scores awarded to a company to the maximum score (27). This score was converted into a percentage form.

3.3. Measurement for Risk Management Disclosure

Index disclosure for RM was developed based on the study conducted by Nu *et al.*, (2011); and Rahman, Kighir, Oyefeso, and Salam, (2013). 33 items was constructed in this index. A dichotomous procedure was applied in scoring the items whereby Specifically, a "1-point" score is awarded for each item that disclose in the annual report and otherwise, a "0-point". Then, the sum of scores of all items is computed. The overall RM score is derived by calculating the ratio of actual sum of scores awarded to a firm to the maximum score (33). This score is converted into a percentage form.

3.4. Measurement for Corporate Governance Disclosure

The measurement for the quality of CG disclosure for this study was based on the CG index adopted from the research conducted by Wan Mohamad and Sulong (2010). According to Wan Mohamad and Sulong (2010) this measurement method has been used extensively by the previous researchers (Chen and Jaggi, 2000; Eng and Mak, 2003; Gul and Leung, 2004; Haniffa and Cooke, 2005; Baraco, Hancock, and Izan, 2006). There are 40 disclosure items. A dichotomous procedure was applied in scoring the items of the CG index. Specifically, a "1-point" score is awarded for each item that is consistent with good corporate governance practice as indicated on the CG Index and otherwise, a "0-point" score was given. Finally, all the disclosure scores are added to get a total score for each company whereby the maximum disclosure score is 40. Then, the sum of scores of all items is computed. The overall CG score is derived by calculating the ratio of actual sum of scores awarded to a firm to the maximum score (40). This score was converted into a percentage form. The scoring approach employed in this study is consistent with the method used in prior studies (Brown and Caylor, 2006; Black, Jang and Kim, 2012; Beiner, Drobetz, Schmid and Zimmerman, 2004; Byun, Kwak and Hwang, 2008; Chen *et al.*, 2009).

3.5. Measurement for Firm's Profitability

A commonly employed measure of profitability is return on assets (ROA) by Brammer and Pavelin, (2008); Cormier, Ledoux, Magnan and Aerts, (2010); Cormier *et al*., (2011) and Lim, Matolcsy and Chow, (2004) and return on equity (ROE) by Ajanthan (2013). Accordingly, profitability in the current study was measured using ROA ratio and ROE.

4. Findings

4.1. Level of Quality of Non-Financial Information Disclosure Quality

As shown in table 1, quality of CG information disclosure has the highest mean (0.8309), followed with IC information disclosure (0.5469), RM information disclosure (0.3465) and the lowest mean was on CSR information disclosure (0.2428).

Table 1. Descriptive Statistics of Quality on NFI Disclosure

	N	Minimum	Maximum	Mean	Std. Deviation
CSR	100	.00	.85	.2428	.18497
RM	100	.03	.74	.3465	.13586
IC	100	.11	.93	.5469	.16967
CG	100	.70	.98	.8309	.06090

4.2. Influence of NFI Disclosure on Firms' Profitability

The result on the influence of NFI disclosure on firms' profitability was presented in Table 2 and Table 3 using ROE and ROA as the measurement of firms' profitability respectively.

Table 2. Regression Analysis on NFI Disclosure and Firms' Profitability (ROE)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	-1.154	.312		-3.701	.000
CSR	.739	.132	.476	5.599	.000
RM	-.326	.180	-.154	-1.811	.073
IC	.297	.149	.176	1.997	.049
CG	1.317	.391	.280	3.368	.001
R^2	.404				
F	16.111				
Sig	.000				

The regression result in Table 2 shows that CSR, IC and CG disclosure have significantly influence the firms' profitability with R^2 of 0.404. This indicated that 40.4% of the variation in firms' profitability can be explained by the quality of NFI. The regression equation was expressed using the following model:

$$\mathbf{ROE = \beta + CSR + RM + IC + CG + e} \tag{1}$$

Table 3. Regression Analysis on NFI Disclosure and Firms' Profitability (ROA)

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.914	.216		-4.224	.000
	CSR	.188	.092	.194	2.050	.043
	RM	-.087	.125	-.066	-.695	.489
	IC	.164	.103	.156	1.593	.114
	CG	1.109	.272	.378	4.084	.000
	R^2	.261				
	F	8.380				
	Sig	.000				

The regression result in Table 3 shows that only CSR and CG disclosure have significantly influence the firms' profitability with R^2 of 0.261. This indicated that 26.1% of the variation in firms' profitability can be explained by the quality of NFI the regression was express using the following model:

$$\mathbf{ROA = \beta + CSR + RM + IC + CG + e} \tag{2}$$

5. Conclusions

This study concluded that among the four categories of NFI that has been examined, CG disclosure has the highest level of quality. It is due to the adequate guideline for disclosing the CG information by Bursa Malaysia in their Listing Requirement. Recognition should be given to Malaysian Code of Corporate Governance for their effort in the development of CG issues in Malaysia. In addition, this study also found that quality of CG and CSR information significantly influenced the firms' profitability using both ROA and ROE measurement. This is consistent with the previous study by Wibowo (2012) and Rouf (2012). Both regression results show that quality of CG information has the highest influenced on firms' profitability. Quality of CG information will increase transparency and able to attract investors' confidence. On the other hand, quality of CSR disclosure able to influence the firms' profitability through customer loyalty and develop good corporate image as public are more concern on environmental issue, marketplace and community. Quality of IC disclosure was significantly influence the firms' profitability using ROE measurement but was insignificant using ROA measurement. This suggests that disclosing quality IC information able to generate higher return on equity as IC is crucial in competitive advantage and value creation. Finally, this study provides a useful insight to the authorities on the level of quality of NFI and this information enables them to focus on areas that need improvement. This study also gives a better understanding to the users of annual reports on the influence of NFI disclosure on firm's profitability

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