The Effect of Voluntary Disclosure on Stock Market Returns of Companies Listed at the Nairobi Securities Exchange

Mirie Mwangi, PhD
Lecturer, University of Nairobi, School of Business
Department of Finance and Accounting
P. O Box 891, SARIT CENTRE, 00606
Nairobi, Kenya

Jacqueline Kendi Mwiti, MSc Finance
KPMG Kenya
P. O Box 40612, 00100
Nairobi, Kenya

Abstract

Voluntary disclosure is aimed at providing a clear view to stakeholders about the business's long-term sustainability and reducing information asymmetry and agency conflicts between managers and investors. The objective of this study was to determine the effects of voluntary disclosures on stock market returns of companies listed at the Nairobi Securities Exchange. The study sampled twenty firms for the period 2009 to 2013. It employed multiple linear regression of market performance of the firms in the five year period against voluntary disclosure, exchange rate, interest rate and rate of inflation.The results were that each of the factors was positively related to market performance for firms listed at the NSE. The study recommends companies to have voluntary disclosure above the statutory requirements set by the regulatory agencies as it can result in increased stock returns.

Keywords: Voluntary disclosure, Stock market return, Nairobi Securities Exchange

Introduction

Stock market return is the yield an investor obtains over a specified period of time. It is sometimes considered to be synonymous to stock prices. A strong market can be seen as one that incorporates new information to stock prices and hence making the stock prices for the firms stable and accurately valued. Due to misvaluations of firms by capital markets, managers provide the information known by them alone to the capital markets to correct the misvaluations, since stocks value is dependent on information. Since organizations in the same industry tend to copy from one another, voluntary disclosure by one organization is mimicked by other firms, leading to more information released to the market tending the capital markets towards efficiency. The information asymmetry and agency conflict can adversely impede the allocation of resources in capital markets of an economy. The disclosure requirements themselves and bodies such as regulators, standards setters, auditors, and capital market intermediaries seek to facilitate and enhance the credibility of management disclosures hence playing an important role in mitigating the problem of information asymmetry and agency conflict. Corporate disclosure is critical for the well functioning of an efficient capital market. Furthermore, companies exercise voluntary disclosures for capital market reasons (Deegan, 2010; Velashani and Mehdi, 2008; and Walter, 2006).

The market forces exerts pressure on the companies' such that they can only give relevant and perceived information so that their securities will fetch reasonable prices hence leverage their ability to get capital from the markets (Healy and Palepu, 2001). In support, Foster (1986) and Lim (2007), asserts that there is a relationship between economic theory and contemporary accounting implying that more disclosure means lower information asymmetry costs. Hence, the more a company discloses its state of affairs, the more it mitigates chances of obligations to shareholders or potential buyers and sellers of the entity's stocks and hence better performance of the market.

Some of the factors that affect the stock returns include voluntary disclosure, interest rate, inflation rate and exchange rates.Meek, Roberts and Gray (1995) define voluntary disclosures as free choices on the part of company managements to provide accounting and other information deemed relevant to the decision making needs of users of their annual reports. They classify voluntary disclosures as strategic, non-financial and financial information. They classify the disclosures depending on what they are intended for and the contents of such disclosed information.

Disclosed financial information is essential for investors to efficiently allocate scarce resources and assess investment options (Meek et al., 1995; and Cooke, 1989). Firms usually report according to two dominant standards; Generally Accepted Accounting Principles (GAAPs) and International Financial Reporting Standards (IFRS). From the investors' perspective, these standards do not provide all the necessary information and as a result there are some deficiencies (Schuster and O'Connel, 2006). Voluntary disclosures results in increased transparency and decreased asymmetry. Agency costs are a consequence of information asymmetry and arise when investors undervalue the firm due to insufficient information (Guillaume, 2007). Increased transparency shows the true value and makes investors more willing to invest (Leuz andVerrecchia, 2000).

The key 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. Meek et al.(1995) postulates that whether strategic, non-financial or financial voluntary disclosures, most organizations gain some benefits by virtue of disclosing more than is expected if the issued information is strategically availed to the important parties who are likely to act in favor of the company. The disclosures are sometimes not periodic while others are periodically released including voluntary disclosures released together with annual reports of an organization (Asava, 2013).

It is the economic benefits that encourage the managers to provide more information to the public through voluntary exposure. Also, since regulatory disclosures do not succinctly reflect the management performance, the management engages in voluntary disclosure to inform more about the company. In turn, the stakeholders get to know more about the company, while reducing the costs of capital. There is an overall economic benefit for companies and the capital market since the cost of raising capital is reduced. Further, the market participants are informed by dealing with the demerits of information asymmetry and its related costs. These factors attract more investors to a market hence an increased stock market return(Healy and Palepu, 2001).

Foreign currency rates have a direct impact on the price and value of stocks in foreign countries, and changes in exchange rates will increase or decrease the cost of doing business in a country, which will affect the price of stocks of companies doing business abroad. While long-term movements in exchange rates are affected by fundamental market forces of supply and demand and purchase price parity, short-term movements are driven by news, events and futures trading and are difficult to predict (Barako, 2007).

If the rates of interest rise, the cost of debt of a firm is affected. This can reduce company profits and the dividends it pays shareholders. As a result, its share price may drop.When interest rates are raised, many investors sell or trade their higher risk stocks for government-backed securities such as bonds to take advantage of the higher interest rates they yield and to ensure that their investments are protected (Fama and French, 1992).

Inflation means higher consumer prices. This often slows sales and reduces profits. Higher prices will also often lead to higher interest rates. Increase in interest rates will tend to bring down stock prices. Commodities however, may do better with inflation, so their prices may rise (Fama and French, 1992).

Research Problem

The Nairobi Securities Exchange (NSE) is the only securities exchange in Kenya. In August 2014, it had a market capitalisation in excess of KShs 2 trillion and 63 listed firms (NSE, 2014).

Some empirical research regarding stock returns and voluntary disclosure include: Singhvi and Desai (1971) who carried out a research on quality of financial disclosure by firms in USA and found out that disclosure quality is better in large firms compared to smaller ones. Dedman, Lin, Prakash and Chang (2008) carried out a research on voluntary disclosure and its impact on share prices. They noted that the reported earnings of high research and development expenditure firms were likely to convey less value-relevant information to investors than those of less research-intensive firms.

Zareian (2012) in his research paper conducted a post event correlation analysis seeking to establish whether there is a significant relationship between information disclosure quality and stock returns change in investment firms and noted that the results kept varying in that in some years there was absolutely no correlation between disclosure quality and stock returns, while there was some correlation in other years. Hail (2002) investigated the impact of voluntary corporate disclosure on the expected cost of equity capital and stated that quality of disclosure is inherently subjective like cost of equity capital and its evaluation is very difficult. Botosan (1997) carried out a study in USA to examine the association between expected cost of equity capital and three types of disclosure and concluded that aggregating across different types of disclosure results in a loss of information and potentially erroneous conclusions.

Lwangu (2009) performed a study to investigate the link between corporate governance, company size and company announcements on disclosure compliance for companies quoted at the NSE. He noted that there was a positive correlation between company size and compliance but a negative correlation with company announcements. Wesonga (2008) in his study on the use of financial disclosures for decision making by investors in Kenya, found out that the majority of the institutional investors use financial disclosures as a source of vital information for investment decisions. Mwirichia (2008) carried out a survey of corporate governance disclosures among Kenyan firms quoted at NSE. He found out that financial sectors make more intensive corporate governance disclosure than the non-financial sector. Barako (2007) in his study of determinants of voluntary disclosures in Kenyan companies annual reports observed that there is no link between organizations' disclosures and their financial performance.

Literature from past studies reveal that most researches have focused on the factors that influence the extent of voluntary disclosure. Those studying the relationship between voluntary disclosure and stock market returns, like Zarein (2012),Wesonga (2008) and Mwirichia (2008) concluded that there was no relationship between voluntary disclosures and stock market returns.Other researchers elsewhere have linked quality of voluntary disclosures and stock returns and in turn the stock market performance. Yet again, some have had conflicting results. Since voluntary information disclosures have a cost implication, there is a need to establish whether voluntary information disclosures impacts the stock market returns expected by the investors. Hence the objective of this study was to determine the effects of voluntary disclosures on stock market returns of companies listed at the Nairobi Securities Exchange.

Methodology

This study employed a descriptive research design. The population for this study included the 63 companies in the Nairobi Securities Exchange as at August, 2014. A sample of 20 companies were selected from the 10 different sectors. The study used secondary data.The study focussed on several categories of common voluntary disclosures, that is: strategy disclosures, competition and outlook, production, marketing strategy, and human capital.For the stock returns, the data on annual dividends and share prices of the sampled firms for the period 2009-2013 were obtained. The data was used to compute the stocks return for each period.

The relationship between voluntary disclosures and stock market performance was specified in the model below:

$R_i = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

Where:

R_i = Actual Stock Return,
α = interecept
X_1 = Voluntary disclosures
X_2 = Exchange rate
X_3 = Interest rate
X_4 = Rate of inflationand
ε = error term.

The disclosure index is based on an investor's perspective, hence the disclosure items incorporated in the disclosure index are based on what investors would be expected to consider as relevant or important. The disclosure index consists of five disclosure categories: (1) strategy, (2) competition and outlook, (3) production, (4) marketing strategy and (5) human capital. It encompasses 62 disclosure items spread among these five categories.The use of the disclosure index measured the amount of voluntary disclosure within annual reports.

This research used the company's annual reports of 2009 to 2013 to create the disclosure index for each year. To measure the amount of voluntary disclosure a binary coding scheme was applied in which the presence of each disclosure item scores one (1) point and the absence of each disclosure item scores zero (0) point. Consequently, one point was assigned to each of the 62 disclosure items that the firms provide through their annual report, whereas each firm could reach a maximum of 62 points. Inflation rate was measured using the Consumer price index(CPI). Interest rate used was the average lending rates by commercial banks. This research used the exchange rate between Kenya Shilling and the USA dollar.

Results and Discussions

Table 1 shows the descriptive statistics from the study where the study variables mean, standard deviation and variance are shown. Voluntary disclosure has a mean of 33.86 and a standard deviation of 4.13, the exchange rate has a mean of 83.22 and standard deviation of 4.3, interest rate mean is 16.76 and a standard deviation of 2.24. Rate of inflation mean is 8.74 and standard deviation of 3.52 and the market performance has a mean of 0.65 and a standard deviation of 0.46.

Table 1: Descriptive Statistics

	Minimum	Maximum	Mean	Median	Std. Deviation
Voluntary disclosures (Index)	26.00	42.00	33.86	33.50	4.13
Exchange rate	77.33	88.86	83.22	84.52	4.30
Interest rate (%)	13.87	20.04	16.76	16.99	2.24
Rate of inflation (%)	4.100	14.00	8.740	9.400	3.52
Market performance	-0.29	1.670	0.650	0.570	0.46

Source: Researcher (2014)

Correlation tests were carried out on the original data to show the extent or strength and direction of the relationship between variables. Table 2 shows correlation of study variables.

Table 2: Correlation among Study Variables

	Market performance	Voluntary disclosures	Exchange rate	Interest rate	Rate of inflation
Market performance	1.000				
Voluntary disclosures	.690	1.000			
Exchange rate	.628	.653	1.000		
Interest rate	.572	.638	.551	1.000	
Rate of inflation	.687	.635	.567	.643	1.000

Source: Researcher (2014)

All the predictor variables had a mildly strong and positive correlation between themselves.The positive correlation means that the variables vary together in the same direction; when any of the variables increase the others increase and when any decrease the others decrease.

The results of the multiple regression analysis are shown in Table 3.

Table 3: Regression Results for Market Return as Dependent Variable and Various Factors as Predictors

a) Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.764(a)	.583	.472	.541

b) Goodness of Fit– ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	6.153	5	1.538	5.248	.000(a)
	Residual	4.397	15	.293		
	Total	10.550	19			

c) Regression Coefficients

Model		B	Std. Error	t	Sig.
1	(Constant)	2.180	.813	2.681	.017
	Voluntary disclosure	.529	.117	4.526	.000
	Exchange rate	.312	.131	2.371	.032
	Interest rate	.321	.148	2.169	.047
	Rate of inflation	.580	.137	4.236	.001

aDependent Variable: Market Performance

The goodness of fit results of standard linear multipleregressionwith market performance as the dependent variable and various determinants as predictors are reported in Table 3 (a). The model summary is in Table 3 (b). The model reveals a statistically significant relationship between financial performance and determinants (Sig.=< 0.05). The multiple regression model had an Adjusted R^2 = .472, F = 5.248, and a standard error of 0.541. The model coefficients are shown in Table 3(c). The findings indicate that the significant predictors of market performance were voluntary disclosures(β = 0.529, p=<0.05), exchange rate(β = 0.312, p=<0.05), interest rate(β = 0.321, p=<0.05), and rate of inflation(β = 0.580, p=<0.05).

The study explored the relationship between market performance and various determinants by suggesting that there is a statistically significant relationship between market performance of firms listed at the NSEand selected factors. Results of this study indicate that the relationship between market performance and selected factors for firms listed at the NSE is statistically significant (p=<0.05) for all the four predictor variables (voluntary disclosure,exchange rate, interest rate,and rate of inflation). The null hypothesis was rejected and therefore the alternate one was accepted, meaning that there is a significant relationship between market performance of firms listed at the NSEand voluntary disclosure,exchange rate, interest rate,and rate of inflation.

The results are consistent with Hail (2002) who studied the impact of voluntary corporate disclosure on the expected cost of equity capital and found that voluntary disclosures had a positive relationship with stock returns. They were however not consistent with Zareian (2012) who in investigating the relationship between information disclosure quality and stock returns of firms listed in the Tehran stock exchange in the period 2004-2008 found that the results kept varying in that in some years there was no correlation between disclosure quality and stock returns, while there were some correlation in other years. The results were also not in line with Asava (2013), who sought to establish the effect of voluntary disclosures on stock returns of companies listed in the Nairobi Securities Exchange. The findings revealed that there is no relationship between voluntary disclosures and stock returns.

The analytical model which was:

$R_i = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

is therefore specified as:

$R_i = 2.180 + 0.529 X_1 + 0.312 X_2 + 0.321 X_3 + 0.580 X_4$

Whereby:

R_i = Actual Stock Return, X_1= Voluntary disclosures, X_2= Exchange rate, X_3=Interest rate,and X_4= Rate of inflation.

Conclusion

Market performance of firms listed at the NSE is positively related to voluntary disclosures in addition exchange rate, interest rate and rate of inflation. Firms would therefore be advised to engage in voluntary disclosure above the statutory requirements set by the regulators as a means to enhance the value of their stocks.

In measuring the amount of voluntary disclosure, this research used a researcher-constructed disclosure index. It can be argued that this type of measurement method is a subjective measurement method of voluntary disclosure. A binary coding scheme was used where 1 was allocated to presence of a disclosure and 0 for absence. The subjective measurement of voluntary disclosures through assigning an index by the researcher would have affected the findings since different researchers would probably use different ratings. The research sample consists of 20 companies listed at the NSE. The companies were spread across the different sectors. Because this is a relatively small sample, this could bias the results. In addition, the selected years 2009 to 2013 may not be enough to generalize the results.

The study recommends that further research focusing on specific industries could perhaps reveal more information as different industries may respond differently to certain information releases. Also, an analysis of the effect of voluntary information release on stock returns as soon as it is released can help depict the short term effect of such information disclosures on stock return. Further studies can be carried out to determine whether or not there is a relationship between the voluntary disclosure and the cost of equity capital in Kenyan context and if it is consistent over the years. Further research can also be carried out to determine the effect of other types of publications disclosure on the stock market returns in comparison to the annual financial reports of the companies listed at the Nairobi Securities Exchange.

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