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An Analysis of Forward-Looking Disclosures, Corporate Governance and the Ability to Anticipate Future Earnings: Empirical Evidence from Indonesia

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This study aims to examine the effect of corporate governance, as measured by the effectiveness of the board of commissioners, the effectiveness of the directors, as well as the concentration of ownership to the level of mandatory forward-looking disclosures in the annual report. This study also aims to test the effect of mandatory forward-looking disclosures in the ability to anticipate future earnings in the current stock price. The results of the study support that the effectiveness of directors is positively associated with the level of forward-looking disclosures and ownership concentration is negatively associated with the level of forward-looking disclosures. However, this study found no significant relationship between the level of forward-looking disclosure and the effectiveness of the board of commissioners. The study also found no association between the level of forward-looking disclosures and the ability to anticipate future earnings in current stock prices.

Keywords: Forward-Looking Disclosure; Board of Commissioners; Directors; Concentrated Ownership; Anticipate Future Earnings.

1. INTRODUCTION

Information transparency has become an increasingly important governance mechanism in discussions regarding the quality of corporate governance[1]. In order to improve the quality of information transparency, the regulatory authorities in Indonesia have established a requirement for mandatory disclosure in the annual reports of companies. This requirement is expected to lead to the provision by companies of comprehensive information in their annual reports, comprising both backward-looking and forward-looking information. Forward-looking disclosure is a class of information that refers to a company's current plans and future forecasts, thus enabling investors and other users to assess a company's future financial performance[2].

The implementation of corporate governance in the monitoring of management is vitally important to reduce information asymmetry between management and shareholders[3]. This is consistent with a study in which it was stated that good corporate governance reduces the amount of information asymmetry between managers and owners and improves levels of corporate disclosure[4]. Many previous studies have been conducted on the association between corporate governance mechanisms and disclosure. However, such studies tended to focus on voluntary disclosure in general and not on any specific type of information such as forward-looking disclosure[5-8].

A study on the association between forward-looking disclosure and corporate governance found that board size and composition are positively associated with forward-looking earnings statements[7]. Furthermore, a forward-looking earnings statement in the annual report helps investors to better anticipate future earnings as measured by the Forward Earnings Response Coefficient (FERC)[9,10].

This study aims to examine the effect of corporate governance mechanisms on the level of mandatory forward-looking disclosure in the annual reports of companies and to examine the ability of mandatory forward-looking disclosure in anticipating future earnings. The corporate governance mechanisms to be examined in this study are the effectiveness of Directors, effectiveness of the Board of Commissioners, and ownership concentration. The sample in this study comprises companies in the manufacturing industry listed on the Indonesia Stock Exchange (IDX) during the period 2012–2013.

Our study extends the prior research about forward-looking disclosure in several aspects. First, this study focuses on mandatory forward-looking disclosure, which contrasts with many prior studies that have focused on voluntary disclosure, based on the assumption that firms tend to comply with disclosure regulation and disclose additional information to the public voluntarily[11]. The existence of disclosure regulation does not always guarantee a higher level of disclosure, especially in the absence of any sanction for non-compliant companies.

This study also differs from earlier research that focused only on certain specific attributes or characteristics of an effective Board of Directors, such as size, independence, or the activity of the board[9]. In this study, the effectiveness of Directors and Board of Commissioners was measured using a checklist that included independence, activity, number of members, and the competence of the Directors and Board of Commissioners as a whole. This checklist was expected to better capture the various aspects that make up the overall effectiveness of Directors and the Board of Commissioners[10]. Finally, this study examines the effect of concentrated ownership on the level of mandatory forward-looking disclosure. The use of concentrated ownership variables reflects, in that the ownership structure of East Asian companies, including those in Indonesia, tends to be concentrated[13].

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

In 2012, the Indonesian Capital Market Authority revised the previously issued rules on disclosure in annual reports. The regulations on disclosure stipulate the minimum information that must be disclosed in the annual reports of companies listed on the Indonesia Stock Exchange (IDX).

The information submitted in annual reports consists of historical information (backward-looking information) as well as forward-looking disclosure. Forward-looking disclosure is presented in several parts of the annual report, namely the Directors' Report, Board of Commissioners' Report, and Management, Discussion, and Analysis. However, the rules of disclosure in Indonesia do not explicitly mention any sanction for companies that do not comply.

One type of information that a company must disclose is forward-looking information. Forward-looking disclosure is significant because it will serve to improve forecasts about the company and ease decision-making processes in the capital market. However, forward-looking disclosure may also lead to greater accountability and an increase in reputational cost[14].

Previous studies have found the level of companies' disclosures to be primarily determined by the incentives that are shaped by the institutional environment, which include corporate governance mechanisms. The effectiveness of corporate governance mechanisms in maintaining a healthy relationship between the management and shareholders depends greatly on board effectiveness[15].

The empirical evidence from previous studies has shown that voluntary disclosure is positively related to independence of the Board[6-8], board activity[8,16], Board size[7], board competence/knowledge[17]. The results of research on the relationship between corporate governance mechanisms and forward-looking disclosure were also consistent with regard to the positive association of board size and board composition with forward-looking disclosure[9].

The Directors and the Board of Commissioners are responsible for corporate transparency as well as compliance with regulations on the disclosure of information in annual reports. Accordingly, it can be expected that effective directors will be more motivated to comply with the regulations on forward-looking disclosure in the annual report and that an effective board of commissioners will strengthen the monitoring of compliance in relation to forward-looking disclosure. Therefore, it is hypothesized that:

H1: Effective Directors is positively associated to the level of mandatory forward-looking disclosure.

H2: Effective Board of Commissioner is positively associated to the level of mandatory forward-looking disclosure.

The structure of ownership determines the level of monitoring and thereby the level of disclosure[18]. In a firm with concentrated ownership, such as those in Indonesia[13], the conflict of interest is no longer between firms' managers and shareholders but between their majority and minority shareholders. In such cases, the majority owners have greater access to internal company information and may therefore be less reliant on public disclosure to monitor their investments. Thus, demand for adequate disclosure and reporting is generally low in such situations[19]. Previous studies have found empirical evidence that concentrated ownership is negatively associated with voluntary earning disclosure[20-23]. Therefore, it is hypothesized that:

H3: Ownership concentration is negatively associated to the level of mandatory forward-looking disclosure.

Future profits together with future earnings will be reflected in the current return[24]. Forward-looking disclosures provide information that will enable investors to better predict future earnings. The disclosure of forward-looking information is also assumed to reduce the information gap between firms and investors by improving the ability to anticipate future earnings[25] and price[26]. Consistent with that finding, it is found that forward-looking earnings statements in annual reports increase the market's ability to anticipate future earnings[10,26]. However, significant results when using a disclosure metric based on all types of forward-looking statements were not found[26]. Therefore, it is hypothesized that:

H4: The ability to anticipate future earnings in share price is positively associated to the level of mandatory forward-looking disclosure.

3. RESEARCH METHOD

The study sample was drawn from manufacturing firms listed on the IDX during the period 2012–2013. The sample was started from 2012 because this was the year in which the capital market authorities implemented new disclosure regulations. This study uses only one industrial sector, namely the manufacturing industry, due to the fact that each industry has different disclosure patterns[19,27] and manufacturing companies are the largest issuers on the IDX. There were 138 manufacturing firms listed on the IDX as of December 31, 2013. A total of 51 firms were subsequently excluded from the sample due to the fact that they used another currency in their financial statement or did not have complete data to enable the hypotheses to be tested. As a result, the sample of this study consisted of 87 firms with a total of 174 firm-year observations.

The data were obtained from several secondary sources. Data on mandatory forward-looking disclosure, the effectiveness of Directors and Board of Commissioners, and ownership concentration and annual returns were obtained from the companies' annual reports as contained on either the IDX website or on each firm's official website. Additionally, the financial accounts data were obtained from Thompson Reuters DataStream.

To test the hypothesis addressing the relationship of effectiveness of directors, effectiveness of the Board of Commissioners, and ownership concentration on mandatory forward-looking disclosure (H1, H2, and H3), a multi-linear regression model is constructed and an unbalanced panel data analysis is performed for the sample of 174 firm-year observations. The regression equation of model 1 is as follows:

$FLD_{i,t} = \alpha_0 + \alpha_1 EDIR_{i,t} + \alpha_2 EBOC_{i,t} + \alpha_3 COW_{i,t} + \alpha_4 LEV_{i,t} + \alpha_5 ROA_{i,t} + \alpha 6SIZE_{i,t}t + \varepsilon_{i,t}$ …… (1)

where $FLD_{i,t}$ is the level of mandatory forward-looking disclosures for firm i in year t; $EDIR_{i,t,}$ is the score of effectiveness of directors for firm i in year t; $EBOC_{i,t}$ is the score of effectiveness of the board of commissioners for firm i in year t; $COW_{i,t}$ is the level of ownership concentration for firm i in year t; $LEV_{i,t}$ is the leverage of firm i in year t; $ROA_{i,t}$ is the profitability of firm i in year t; and $SIZE_{i,t}$ is the size of firm i in year t.

FLD is measured using the mandatory FLD checklist. This checklist was constructed based on the checklist of Liu[29] and modified to fit with the mandatory disclosure requirement from the Capital Market Authority in Indonesia. EDIR and effectiveness of Board of Commissioners (EBOC) was assessed with the checklist[12]. The checklist for EDIR comprises three components: activity, size, and the competence of directors. The checklist for EBOC consists of four categories, namely independence, activities, size, and competence of the board of commissioners.

Model 2 is used to test hypothesis H4, addressing the effect of FLD on the ability to anticipate future earnings in share price. In model 2, the stock market's ability to anticipate future earnings in share price uses the proxy of the FERC based on Collins et al.[24].

$R_{i,t} = \beta_0 + \beta_1 E_{i,t-1} + \beta_2 E_{i,t} + \beta_3 E_{i,t+1} + \beta_4 R_{i,t+1} + \beta_5 FLD_{i,t} + \beta_6 FLD_{i,t}*E_{i,t-1} + \beta_7 FLD_{i,t}*E_{i,t} + \beta_8 FLD_{i,t}*E_{i,t+1} + \beta_9 FLD_{i,t}*R_{i,t+1} + \beta_{10} MVE_{i,t} + \varepsilon_{i,t}$ …… (2)

where $R_{i,t}$ is the annual stock return for year t; $E_{i,t-1}$ is net income in year t-1; $E_{i,t}$ is net income in year t; $E_{i,t+1}$ is net income in year t+1; $R_{i,t+1}$ is the annual stock return for year t+1; $MVE_{i,t}$ is the market value of common equity; and FLD is the level of forward-looking disclosure. The effect of forward-looking disclosure on the ability to anticipate future earnings in the current share price is shown by the coefficient β_6 of variable interaction $FLD_{i,t}*E_{i,t-1}$, known as the FERC.

4. RESULTS AND DISCUSSIONS

Panel A on Table 1 contains the descriptive statistics of variables used in model 1, while panel B of Table 1 reports the means of each category of mandatory forward-looking disclosure. Panel A in Table 1 shows that the mean for forward-looking disclosure is only 32.6%, thus indicating that the compliance level of the companies in the sample in fulfilling the mandatory forward-looking disclosure in their annual reports is very low. These results are consistent with previous empirical evidence that shows the forward-looking disclosure practices of firms to be relatively conservative since the disclosure of this information is costly[28].

The EBOC is relatively fair, with a mean of around 73.5%. Moreover, the effectiveness of Directors (EBOD) is relatively good, with a mean of around 84.5%. The mean of concentration ownership (COW) is 51%, indicating a concentration of ownership by one shareholder to be widely adopted by the sample firms.

In addition, panel B of Table 1 shows that the lowest values of mandatory forward-looking disclosure concern quantitative information, that is, quantitative prospects of international market (6%) and targets and realization of capital structure (7%). While the highest values for forward-looking disclosure are for general and qualitative information such as qualitative industry outlook (77%) and qualitative economic prospect (64%).

Table.1. Descriptive Statistics of Variables in Model 1

A. Research Variables of Model 1

Variable Name	Mean	Standard Deviation
FLD	0.3263	0.2061
EDIR	0.8455	0.1152
EBOC	0.7350	0.0603
COW	0.5099	0.2343
LEV	0.2409	0.2161
ROA	0.0663	0.1023
SIZE *)	7,097,585	22,922,773

*) in million rupiah

B. Forward-Looking Disclosure (FLD)

No.	Category of Forward-Looking Disclosure	Mean
1	Industry outlook - qualitative	0.7701
2	Industry outlook - quantitative	0.2816
3	The economic outlook - qualitative	0.6437
4	The economic outlook - quantitative	0.3506
5	Prospects for the international market - qualitative	0.4483
6	Prospects of international markets - quantitative	0.0632
7	Target and revenue	0.4080
8	Target and realized gain	0.2931
9	Target and realization of capital structure	0.0747
10	Projected revenue	0.3851
11	Projected profit	0.2241
12	Projected capital structure	0.1347
13	Projected dividend policy	0.1609
Total		0.3263

The descriptive statistics of all variables used in model 2 are presented in Table 2, which shows Variable $R_{i,t}$ as having an average value of 0.1864. This shows that, in general, the companies studied had an average value of daily stock returns over the year of 18.64%. Seeing the declining trend of the average values of variables E_{t-1}, E_t, and E_{t+1}, it can be concluded that the average value of the net incomes of the sample companies continues to decline.

Table.2. Descriptive Statistics of Variables in Model 2

Variable	Mean	Standard Deviation
R_t	0.1864	0.4512
FLD	0.3263	0.2061
E_{t-1}	0.1214	0.3033
E_t	0.0731	0.2576
E_{t+1}	0.0372	0.2212
R_{t+1}	0.0431	0.3185
MVE*)	17,818,427	55,410,059

*) in million rupiah

Table 3 presents the results from model 1 using a fixed-effects regression with generalized least squares (GLS). Based on Table 4, the variable EBOC has a positive but insignificant coefficient. This indicates that effectiveness of Board of Commissioners has no effect on the level of forward-looking disclosure. Thus, hypothesis H1 stating that effective board of commissioners is positively associated with the level of forward-looking disclosure is rejected. This result may be due to the board of commissioners being more focused on strategic corporate decisions.

The EBOD variable has a positive and significant coefficient at the 5% level. This result indicates that the effectiveness of Directors has a positive influence on the level of mandatory forward-looking disclosure. Thus, hypothesis H2 that the effectiveness of directors is positively associated with the level of mandatory forward-looking disclosure cannot be rejected. These results are consistent with a previous study[10].

The COW variable has a negative coefficient and is significant at the 1% level. This result indicates that ownership concentration has a significantly negative influence on the level of mandatory forward-looking disclosure. Thus, hypothesis H3 that the concentration of ownership is negatively associated with forward-looking disclosure cannot be rejected. These results are consistent in finding that the concentration of ownership negatively affects voluntary disclosure[20-23].

Table 3. Regression Result: The Effect of Corporate Governance on the Level of Forward-Looking Disclosure

Variable	Expected Sign	Coefficient	Significance
Cons		0.1016	0.3135
EDIR	+	0.2675	0.0305*
EBOC	+	0.2248	0.2100
COW	-	-0.2421	0.0000**
LEV	+	-0.1566	0.0365*
ROA	+	-0.0865	0.3250
SIZE	+	0.0238	0.0215*

F-test = 0.0000
Adjusted R-squared = 0.1336
** significant at the 1% level, * significant at the 5% level 5%

Table 4. Looking Disclosure on the Ability to Anticipate Future Earnings in Share Price

Variable	Exp. Sign	Coefficient	Significance
Cons		-24.6439	0.0080
E_{t-1}	-	0.0158	0.4875
E_t	+	2.0253	0.0010**
E_{t+1}	+	1.1403	0.0290*
R_{t+1}	-	-0.0942	0.4010
FLD	+	0.1497	0.3520
FLD*E_{t-1}	-	-0.1773	0.4480
FLD*E_t	+	-2.0237	0.1410
FLD*E_{t+1}	+	-0.3271	0.4450
FLD*R_{t+1}	-	-0.2154	0.3790
MVE	+	0.8876	0.0080**

F-test = 0.0000
Adjusted R-squared = 0.4686
** significant at the 1% level, * significant at the 5% level

Table 4 presents the results of model 2 using a fixed-effects regression. It shows that the coefficient of FLD*E_{t+1} is negative but not significant. This indicates that the ability of future earnings is not related to the level of mandatory forward-looking disclosure. Based on this finding, hypothesis H4 that the ability to anticipate future earnings in share price is positively related to the level of mandatory forward-looking disclosure is rejected.

5. CONCLUSION

The results show that a corporate governance mechanism in the form of effectiveness of directors has a positive effect on mandatory forward-looking disclosure, while the mechanism of board of commissioners has no significant effect on the mandatory forward-looking disclosure, and the concentration of ownership has a negative relationship with mandatory forward-looking disclosure. This study has also found that the level of mandatory forward-looking disclosure does not significantly affect the ability to anticipate future earnings in stock price. This is most likely due to the low level of presentation of forward-looking information in the annual reports of the companies studied.

The limitation of this study is its use of only the manufacturing industry in its research sample, which was selected due to it accounting for the largest proportion (30%) of the companies listed on the IDX. In future studies, it would be better to use a research sample encompassing a wider variety of industries. Further research should also separate concentrated forms of ownership into family ownership and non-family ownership. This is because family ownership has different characteristics to other types of concentrated ownership.

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