Strategic implications of voluntary disclosure and the application of the legitimacy theory

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Abstract:
A broad and in-depth review of voluntary disclosure, as the consequential reflection of corporate governance, provides alternative explanations for some the research results discussed in the traditional literature. With regard to the implications of the information asymmetry and the agency theory on voluntary disclosure, we see that the correlation of such is not absolute. In this paper, our understanding in the subject matter is deepened, as we evaluate the various dimensions of corporate disclosure both from a theoretical and an empirical point of view. We discuss the strategic effects as well as the incentives behind corporate disclosure while mirroring the disclosure theory to the legitimacy theory in real life business settings. As we discuss the potential conflicts and drawbacks that researchers and practitioners may have encountered in their previous research, we have discovered that many fundamental research questions related to voluntary disclosure have, in fact, remain unanswered as a result of mixed interpretations. Finally, we propose directions for future research, and subsequently open new research arena to be tested by further research.

Keywords: corporate disclosure; corporate governance; agency theory; information asymmetry
JEL codes: F23, O30, M16

1. INTRODUCTION
The legitimacy theory is often associated with concepts of managerial science, sustainable development as well as voluntary disclosure, which can be both social and environmental; all of which are equally important to long-term business success. As a matter of fact, there is a growing interest in the legitimacy and the disclosure theory, as can be seen from the research emphases that have been put on them in the corporate governance literature. However, the definition of the legitimacy theory is rather broad and covers a spectrum of management activities, which are deemed proper according to a set of societal norms. Nevertheless, the close link of the legitimacy theory with voluntary disclosure is witnessed by their likelihood in quantifying the effects of organizational behavior. These behaviors whose social values are in line with the expectations of the society and moral beliefs seem to
enhance firm performance both in the short run and in the long run, and thus deserves research merits on its own. As a matter of fact, the application of the legitimacy theory in a real life business setting is reflected by a number of socially desired business activities that are primarily performed in return for benefits that are otherwise unattained without these actions.

Hooghiemstra (2000) has addressed the topic of corporate social reporting utilizing the legitimacy theory. In other words, the author believes that corporates disclose social and environmental information as a result of public pressure and media attention; and that social disclosure is a strategy to affect the public perception about the legitimacy of the organization. Consequently, when it comes to the topic of corporate communication, the information from corporate social reporting can be used to understand the corporate identity along with the corporate brand. O'Donovan (2002) has analyzed the reasons why companies disclose environmental information in the annual reports. The author has aimed to find empirical evidence for the legitimacy theory in real life business settings. The author has explained voluntary corporate disclosure in terms of sustainable businesses in which firms must act in a socially acceptable manner. The author has also found supporting evidence for the legitimacy theory as the explanatory factor for corporate disclosures.

Researchers have been interested in the cause and consequences of voluntary disclosure. For publically listed companies, the amount, depth and quality of disclosed information affect the reputation, competitiveness and image of the company in the public eyes. Disclosure on its own does not add business values. The top management has begun to recognize the need for a better strategy in tackling corporate disclosure. While regulations and business interests both require management to disclose a certain amount of information, the public is also interested in information that is beyond the requirement of law. This pressure on the top management to reveal their social responsibilities has pushed corporate disclosure to a new dimension. Moreover, the growing importance of sustainable development has resulted in the rising interests in corporate disclosure. When it comes to corporate governance, it seems that voluntary disclosure is an effective way to measure management efficiency and financial success. Therefore, there has been a great dedication of effort invested in the research of voluntary disclosure in the arena of managerial science. The legitimacy theory, on the other hand, has received a controversial public response. Empirical cases seem to both support and contract the legitimacy theory. Nevertheless, it is acknowledged that both the legitimacy theory and voluntary disclosure include some degree of social characteristics.

Researchers have now gone beyond the sheer definition of the legitimacy to the stage of linking the legitimacy theory with the disclosure theory in order to further our understanding of corporate governance. Given the mixed results on the legitimacy theory and voluntary disclosure, the aim of this research is to form a holistic picture on the subject matter from different perspectives in order to clear our understanding in voluntary disclosure. Consequently, we differentiate between the propensity of companies to engage in voluntary disclosure, the academic view of
voluntary disclosure, the empirical evidence of voluntary disclosure and finally the strategic implications of voluntary disclosure in the following sections.

2. LITERATURE ON CORPORATE DISCLOSURE

The popularity of the legitimacy theory and the disclosure theory is seen through the large amount of research effort dedicated in the subject matter. We have collected selected articles, which are representative of the trend, on voluntary disclosure in Table 1.

Table 1. Theoretical Articles on Voluntary Disclosure

<table>
<thead>
<tr>
<th>Author(s) and Year</th>
<th>Research Nature</th>
<th>Key Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dontoh (1989)</td>
<td>Product theory</td>
<td>Value-maximizing firms may voluntarily disclose unfavorable information</td>
</tr>
<tr>
<td>Darrough and Stoughton (1990)</td>
<td>Signaling theory</td>
<td>Disclosing proprietary information provides strategic information to competitors but is useful to financial forecasts.</td>
</tr>
<tr>
<td>Verrecchia (1990)</td>
<td>Agency theory</td>
<td>The potential for full disclosure is associated with the quality of information and the level of competition.</td>
</tr>
<tr>
<td>Wagenhofer (1990)</td>
<td>Cost theory</td>
<td>Higher proprietary costs of higher risk of an adverse action can make disclosure more or less likely.</td>
</tr>
<tr>
<td>Gigler (1994)</td>
<td>Signaling theory</td>
<td>Firms disclose private information when verification is impossible, and such disclosures can be credible.</td>
</tr>
<tr>
<td>Feltham and Xie (1992)</td>
<td>Signaling theory</td>
<td>Partial disclosure exists when an informed manager wants to communicate good news and hide bad ones to the capital market but other way around to competitors.</td>
</tr>
<tr>
<td>Clinch and Verrecchina (1997)</td>
<td>Agency theory</td>
<td>Competitive disadvantages and intensive competitions decrease companies’ incentives to disclose information.</td>
</tr>
<tr>
<td>Penno (1997)</td>
<td>Information asymmetry theory</td>
<td>Higher informational asymmetry is not accompanied by more voluntary disclosure.</td>
</tr>
<tr>
<td>Healy and Palepu (2001)</td>
<td>Financial reporting theory</td>
<td>Current research on financial reporting and disclosure has provided a number of useful insights.</td>
</tr>
<tr>
<td>Korn and Schiller (2003)</td>
<td>Corporate governance theory</td>
<td>The previous result that in equilibrium firms should disclose all their private information is not convincing.</td>
</tr>
<tr>
<td>Fishman and Hagerty (2003)</td>
<td>Product theory</td>
<td>Mandatory disclosure is necessary in markets where product information is difficult to understand.</td>
</tr>
<tr>
<td>Hughes and Pae (2004)</td>
<td>Asset theory</td>
<td>Only high precision information is disclosed</td>
</tr>
<tr>
<td>An et al. (2011)</td>
<td>Information asymmetry theory</td>
<td>Motivation for disclosure includes reducing information asymmetry; discharging accountability to stakeholders; and to signaling organizational legitimacy and excellence.</td>
</tr>
</tbody>
</table>

Source: own study on the basis of included literature.

McWilliams et al. (2006) raised the strategic importance of corporate social responsibilities in corporate governance. The authors proposed to analyze corporate social responsibility using a theoretical framework and defined corporate social responsibility to be voluntary actions that contribute some degree of social value to
the society. Consequently, there is a positive trend in the research of corporate social responsibility as sustaining competitive advantage. Healy and Palepu (2001) have confirmed the importance of voluntary disclosure, which can be seen as part of corporate social responsibility. However, in the reality, in line with the research results of Fishman and Hagerty (2003), companies choose to voluntarily disclose information when doing so would bring them some of value than otherwise. As a matter of fact, companies disclose information that are not required by law but choose to do so under public pressure. Therefore, voluntary disclosure is justified in cases when there is a clear reason of doing so and consequential effects of doing otherwise, as confirmed by Wagenhofer’s (1990) research.

Darrough and Stoughton (1990) differentiated between the costs and benefits of voluntary disclosure in terms of investors and competitors. Corporate disclosure poses a clear trade-off for management who wants to please their investors but to prevent their competitors from taking advantage of the disclosure. As a matter of fact, researchers such as Clinch and Verrecchina (1997) together with Darrough and Stoughton (1990) have confirmed the fact that the level of competition in the market plays a vital role in the extent of disclosure. When it comes to the information asymmetry between the company and the investors, Penno (1997) believes that information asymmetry does not have merits on its own in terms of voluntary disclosure, while An et al. (2011) believes that companies want to tighten the information gap with the outside environment. Given these mixed research results, it is no doubt that voluntary disclosure is an important topic of research, while the incentive to do so remains unclear.

Dontoh (1989) has shown that not all information, which is voluntarily disclosed are positive by nature, which contradicts the fact that companies use voluntary disclosure as a strategy to enhance their reputation. Gigler (1994) together with Hughes and Pae (2004) have argued that the quality of disclosure can be measured in terms of credibility, which separates our understanding of the quality of disclosure from the content of disclosure. Feltham and Xie (1992) together with Korn and Schiller (2003) have argued that disclosed information may also be misleading by nature, as companies disclose information based on its credibility instead of its authenticity. Subsequently, we see that the discussion in this section has focused on the theoretical development of voluntary disclosure, which has gained mixed as well as controversial results based on the previous research. Therefore, the need for empirical analysis on the subject matter is strong.

### 3. STRATEGIC IMPLICATIONS OF VOLUNTARY DISCLOSURE

While the theoretical development of voluntary disclosure has been well explored, the strategic implications of the subject matter still remain fully unexplored. First of all, voluntary disclosure needs to be properly defined. We also need to identify the different factors that affect the level of disclosure via empirical analysis. The incentives to disclose information needs to be classified along with the effects of
the disclosure. Likewise, the implications of voluntary disclosure on corporate governance including the demand and the related costs of this activity can be quantified via empirical cases.

**Theoretical Issues to Be Resolved**

While the legitimacy theory is understood to include concepts such as corporate social responsibilities, environmental policies and corporate philanthropy, voluntary disclosure is often associated with disclosure in intellectual capital and intangible assets. The ambiguity in the definitions of these concepts makes it difficult to compare the research results of these studies. Having a consensus on the definition of voluntary culture is especially useful in the modeling of corporate governance in determining the strategic implications of disclosure activity within an organization.

Admittedly, mixed results on voluntary disclosure make it difficult to quantify the exact cause and consequence of the disclosure activity. While voluntary disclosure is favorably viewed as contributing social values, it is not clear the true motives behind this tendency. As a matter of fact, despite the fact that voluntary disclosure is used for marketing and control purposes, based on the annual reports it is still difficult to find persuasive information for the private incentives behind the disclosure. Incentives behind voluntary disclosure can be examined via research methods such as interviews and surveys. Having these theoretical issues resolved would allow us to analyze the role of voluntary disclosure in the management decision making process and clear out the cause plus consequences of doing so.

Strategic implications of voluntary disclosure views disclosure as a value-generating activity with the motivation to generate both social values and private values and that both types of value would be in balance. In situations where social responsible actions necessitate sacrifices of private benefits, the source of motivation behind voluntary disclosure may not originate from inside the company but would be a result of public pressure. We differentiate the motivation to serve others at the costs of private benefits as opposed to privately responsible actions that invite social costs. When privately responsible actions generate social values as a consequence, this would benefit the company and the society as well. This type of voluntary disclosure is similar to the case of externalities. In other words, disclosure may generate positive externalities that are beneficial to the public Nevertheless, it is often the case that trade-off between private benefits and social values results in management acting in a way that is not beneficial to the society.

The positive externality of voluntary disclosure can be increased by understanding the incentives for companies to do so. When the disclosure activity can be used as a strategy to generate values for the company, management may find it easier to do so. Besides the benefits of reputation and branding, the tendency of companies to disclose strategic information depends on the industry type and public response to it. One of the best motivation factors for companies to disclose information is when customers are willing to pay a premium for such an activity. That is, when financial benefits result from voluntary disclosure, companies have more
inculcated incentives to behave in such a socially responsible manner. Increasing supply of voluntary disclosure would be a direct response to the increase in the profit margins.

In addition to the incentives to disclose information, the analysis of voluntary disclosure as a socially responsible activity also deserves research on its own. Answer to this question is not so obvious. The case when companies do well by being socially responsible is different making profits via the manipulation of information. While the alignment of financial performance and social performance has been already established, the effect of voluntary disclosure may not always be positive given the quality, content and the amount of information that is being disclosed. Research on voluntary disclosure reveals important strategic implications of the legitimacy theory. Both as a strategy to differentiate and to excel, voluntary disclosure have a vital role to play in the corporate governance arena.

Analysis of voluntary disclosure from the strategic implications’ point of view is admittedly challenging and complicated by both firm-specific and industry-specific factors. Nevertheless, with the rising recognition of voluntary disclosure as sustaining competitive advantage, the application of the legitimacy theory to real life business settings also becomes ever more important. In summary, research on voluntary disclosure suffers from definition-related issues. Distinguishing between the strategic implications of corporate disclosure, socialistic corporate disclosure and coerced corporate disclosure would be a significant theoretical development. In addition, the mixed and sometimes even contradictory results on voluntary disclosure so far would benefit from stringent empirical tests.

4. EMPIRICAL ANALYSIS OF VOLUNTARY DISCLOSURE

In order to quantify voluntary disclosure in real business settings, we need to measure the level of disclosure in the annual reports. Admittedly, difficulties associated with the measurement of voluntary disclosure also hinder our understanding in the strategic implications of the legitimacy theory. One of the main challenges in the empirical analysis of the disclosure theory lies in the lack of unified measurement standards in terms of the level of disclosure. As long as there exist mixed results over the definition of voluntary disclosure, it would be difficult to measure and compare empirical results on the subject matter. Table 2 summarizes the research trend on voluntary disclosure based on selected articles.

Simon and Wong (2001) have tested a theoretical framework related to a set of corporate governance attributes and voluntary disclosure using a sample of publicly listed companies. The number of independent directors and the existence of a voluntary audit committee have found to be associated with an increasing amount of voluntary disclosure. This effect is confirmed by researchers such as Cheng and Courtenay (2006). Chau and Gray (2002) distinguished the low level of disclosure in family-controlled families. Eng and Mak (2003), on the other hand, have done a research on the impact of ownership structure as well as board composition and voluntary disclosure. Their results show that increased disclosure is mainly associated with lower managerial ownership and higher government ownership, lower
outside directors, larger firms and firms with lower debt. Similar results were obtained by researchers such as McKinnon and Dalimunthe (1993); Hossain et al. (2007).

Table 2. Empirical Articles on Voluntary Disclosure

<table>
<thead>
<tr>
<th>Author(s) and Year</th>
<th>Subject Nature</th>
<th>Key Argument/Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chow and Wong-Boren (1987)</td>
<td>Disclosure practices of Mexican corporations</td>
<td>The extent of disclosure is positively related to firm size but not to financial leverage and assets in place.</td>
</tr>
<tr>
<td>McKinnon and Dalimunthe (1993)</td>
<td>Based on a sample of 65 listed Australian companies</td>
<td>Ownership diffusion, the level of minority interest in subsidiaries, firm size and industry membership influence voluntary disclosure of segment information.</td>
</tr>
<tr>
<td>Raffournier (1995)</td>
<td>Multiple regression of 161 Swiss listed companies</td>
<td>Size and internationality affect the disclosure policy of companies.</td>
</tr>
<tr>
<td>Inchausti (1997)</td>
<td>Panel data analysis of 49 Spanish companies for three different years</td>
<td>Size, auditing and stock exchange influence the level of disclosure</td>
</tr>
<tr>
<td>Lang and Lundholm (2000)</td>
<td>Disclosure activity was increased six months before the offering</td>
<td>Increased disclosure may have been hype, which may have been successful in lowering the cost of equity capital.</td>
</tr>
<tr>
<td>Chau and Gray (2002)</td>
<td>Financial reporting practices of listed companies in the Asian settings</td>
<td>The extent of disclosure is likely to be less in family-controlled companies, a feature of the Asian stock markets.</td>
</tr>
<tr>
<td>Eng and Mak (2003)</td>
<td>Sample firms listed on the Stock Exchange of Singapore at the end of 1995</td>
<td>Lower managerial ownership and significant government ownership are associated with increased disclosure.</td>
</tr>
<tr>
<td>Prencipe (2004)</td>
<td>A multiple regression of 64 Italian listed companies</td>
<td>Proprietary costs limit the incentive for segment disclosure to the market.</td>
</tr>
<tr>
<td>Legoria (2005)</td>
<td>Firms in the pharmaceutical industry during 1989-1997</td>
<td>When firms are faced with potentially increased political costs would respond by not disclosing advertising costs.</td>
</tr>
<tr>
<td>Cheng and Courtenay (2006)</td>
<td>Sample firms listed on the SGX at the 2000</td>
<td>A higher proportion of independent directors on the board are associated with higher levels of voluntary disclosure.</td>
</tr>
<tr>
<td>Hossain et al. (2007)</td>
<td>The priori expectations were based on the agency theory</td>
<td>Firm size, foreign listing status and leverage are related to the extent of voluntary disclosure</td>
</tr>
<tr>
<td>Heitzman et al. (2010)</td>
<td>Correlation and regression analysis of the advertising disclosure decision</td>
<td>Voluntary disclosure incentives are in place when the information is less likely to be material.</td>
</tr>
</tbody>
</table>

Source: own study on the basis of included literature.

Adams (2002) has shown that traditional literature on the corporate social reporting was closely linked to the impact of different corporate characteristics, such as size and industry grouping. As a matter of fact, Chow and Wong-Boren (1987) were the first ones to establish a positive relationship between firm size and the level of disclosure, which was later confirmed by researchers such as Inchausti (1997); Raffournier (1995).
Maignan and Ralston (2002) have done an empirical study on the corporate communication in terms of voluntary disclosure. For companies to appear socially responsible, voluntary disclosure is one of the important means to convey social meanings. Leuz and Verrecchia (2000) have questioned the correlation between voluntary disclosure and financial success given the existing reporting standards. Lang and Lundholm (2000) have also questioned the pure intention of companies to disclosure strategic information as part of their corporate social responsibilities. It is not clear that voluntary disclosure would automatically benefit neither the society nor the company in the long run, as shown by researchers such as Heitzman et al. (2010); Prencipe (2004) and Legoria (2005). As a matter of fact, Patten (2002) has concluded that while firm size and industry classification are shown to affect voluntary disclosure, there is a negative correlation between corporate performance and the degree of disclosure.

5. CONCLUSIONS

We define voluntary corporate disclosure to be the provision of company information, which is not required by the accounting regulations and government rules. Research in financial reporting has confirmed such information to be of strategic importance. Companies not only voluntarily reveal information for strategic purposes but this activity may be carried out extensively in order to satisfy the needs of outside investors. Companies may disclose information on the characteristics and strategies of their operations or reveal the impact of their socially responsible practices. Therefore, voluntary disclosure is vital not only to the investors but also to the stakeholders in terms of reducing conflict of interests and information asymmetry. Given the disclosed information, investors can make correct financial decisions benefiting the capital market and the general economy. The strategic disclosure of corporate information enhances competitive advantage.

Voluntary disclosure and financial reporting are important means for management to communicate information about their companies to the public. Therefore, frameworks to measure and evaluate voluntary disclosure remain a key focus in the managerial research arena. It is acknowledged that the level of disclosure is influenced by the level of regulations. On a micro level, voluntary disclosure provides the communication means to the outside investors and stakeholders. On a macro level, corporate disclosure is the foundation for an efficient capital market. Companies have incentives to disclosure corporate information when doing so is beneficial. Especially when it is making equity offerings and issuing new capital, it has high incentives to use disclosure as a strategy in return for a lower cost of capital. Moreover, when the board of directors and investors put pressure on the managers to perform, managers may also use voluntary disclosure to explain their poor performances.

In this paper, we have reviewed important academic and empirical research on voluntary disclosure summarizing the historical trends in the subject matter and identifying areas for future research. We have explained the capital market demand
for voluntary disclosure as well as the implications of information asymmetry and the agency conflicts on the level of disclosure. The incentives to disclose corporate information may firm-specific or industry-specific. However, given the mixed research results on the subject matter, our study contributes values to those who wish to have a holistic picture of the legitimacy theory and voluntary disclosure. When it comes to the reliability of this study, it is acknowledged that the research results discussed in this paper may suffer from the problem of endogeneity and measurement errors. While research interests in voluntary disclosure will continue to grow in the future due to the rising importance of sustainable development, both the legitimacy theory and the disclosure theory will be affected by these global changes.

Conflicting interests between the managers and the outside investors result in information asymmetry, which hinder the efficiency of the capital market, which implies that the capital market will overvalue and undervalue some investment opportunities. The information asymmetry problem can be solved via optimal contracts and regulations in which the managers are forced to disclose private information. Nevertheless, from the capital market point of view, it is interesting to see whether information intermediaries, such as the analysts, can compensate for this information asymmetry completely without having the managers to fully disclose their corporate knowledge to the investors.

When managers behave in a way that harms the interests of the investors, conflicts between self-interests and public interests creates the agency problem. Investors’ properties may be invested in highly risky projects that are financed by additional debts. The nature of the asset and the dividend management policy may benefit the managers in the long run but poses significant risks to the investors especially during financial distress. In order to align the interests of the managers and the investors in this case, compensation agreements, debt contracts and independent board of directors may require the managers to disclose valuable information that are critical to the decision-making process of the investors that would be otherwise undisclosed. Market also poses pressure to the managers in terms of hostile takeovers in case of poor financial performances. The question here would be the role of competition, which we have established before, whether such market forces would reduce the interest gaps between the managers and the investors. The following research questions are raised:

1. What would be the optimal level of regulation that balances the conflicting interests between the managers and the investors?
2. How effective are the existing accounting guidelines in influencing the management decisions?
3. How effective are the information intermediaries in strengthening the capital markets?
4. How can we improve the incentives for managers to engage in voluntary disclosure that result in positive externalities?
5. What are the differences between a free market approach to disclosure as opposed to regulated corporate disclosure?
6. Can voluntary disclosure deter new entrants to the market?
7. To what extent can we regulate the independence of the board of directors?
8. How do we measure and quantify the effectiveness of voluntary disclosure?
9. To what extent does the capital market contributes to economic growth?
10. What are the implications of international cooperation in the area of financial reporting on voluntary disclosure?

Market imperfections including externalities are the reasons behind the conflicting incentives of voluntary disclosure. As a result of information asymmetry, research has shown the justification for an extensive level of regulations attempting to correct for the imperfections. The gap between the informed and uninformed can also be reduced through regulations. Voluntary disclosure would potential investors to free ride the information paid by existing stockholders leading to its underproduction. It would be interesting to know how market failure in this case would affect the operating environment for new entrants.

The existence of an independent audit committee is confirmed to contribute to the credibility of the information disclosure, as stock prices react to earnings announcements. However, it has been shown that auditors mainly act in the interests of the managers instead of the interests of the public. Future research may choose to distinguish these conflicts of interests, and thus clear the role of the auditors in voluntary corporate disclosure. By information intermediaries, we mean financial analysts who collect data to evaluate the performances of the companies that they are following in order to make recommendations. While information intermediaries add value to the capital market, there exists a consistent bias in their analyses either being too optimistic or too negative. At the same time, it is acknowledged that the self-interests of the analysts, similar to the case of the audit committee, getting rewards for generating profits for their brokerage houses, would not always act in the best interests of the public. We have shown that there are still many research questions related to voluntary disclosure that remain unanswered.

REFERENCES


