

# [Nairobi securities exchange](https://assignbuster.com/nairobi-securities-exchange/)

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Investors use earning information to calculate the level of cost of equity capital. The cost of equity for a firm is computed by adding up the risk free rate and a premium for exposure to systematic risk as follows: Cost of equity = Risk-free rate + (risk measure) x (Market risk premium)

1. 4 Nairobi Securities Exchange

The Nairobi Securities Exchange offers a trading platform for both the local and international investors who are looking to gain exposure to Kenya and Africa's economic growth. NSE play a critical role in the growth of Kenya's economy by encouraging savings and investment by helping local and international companies access cost-effective capital. NSE is regulated by the Capital Markets Authority of Kenya.

CMA approves public listing and fosters investor's confidence by ensuring rules, regulations and requirements for trade are complied with and market integrity is sustained in order to guarantee orderly, fair and efficient markets (CMA, 2016). CMA retains investor's confidence by ensuring rules, regulations and requirements for trade are complied with and market integrity is maintained.

CMA also plays an importantresponsibilityof mobilization and allocation of capital resources in the economy in order to provide incentives for long term investments (NSE, 2016) In Kenya, listed firms are required to produce quarterly, semi-financial statements and audited annual reports. Financial statements are prepared according to International Financial Reporting Standards (IFRS) and audited using International Standards on Auditing (ISA).

The CMA guidelines encourage firms to disclose additional information on director and management remuneration (CMA, 2016). The performance of the NSE is an indication as to whether the investors have trust in the safety of their investment, trading goes down significantly with low investor's confidence. NSE is categorized into three different market segments namely the Main Investment Markets (MIMS), the Alternative Investment Markets (AIMS) and the Fixed Income Securities Market Segment (FISMS).

According to CMA (2017) as at December 2017, listed companies at the NSE were 64, categorized into 11 sectors namely: Agricultural sectors, Automobiles and Accessories sector, Banking sector, Commercial and Services sector, Construction and Allied sector, Energy and Petroleum sector, Insurance sector, Investment sectors, Manufacturing and Allied sector, Telecommunication andTechnologysector and Growth and Enterprise Market Segment sector Banking sector is the largest sector represented with 18% of the total firms listed at the NSE, second is commercial and Services sector and Manufacturing and Allied with 15% each, Agricultural sector which is one of the country major economic sector is represented by 11% of the total firms quoted.

Telecommunication and Technology and Growth and Enterprises Market sectors were the lowest each with 2% of the total firms quoted. Through NSE, disclosures have had an impact on how investors trade, when the level of disclosure is high, investors confidence increases hence higher level of trading. The CMA guidelines encourage firms to disclose additional information on director and management remuneration (CMA, 2016).

The performance of the NSE is an indication as to whether the investors have trust in the safety of their investment, trading goes down significantly with low investor's confidence. 1. 5 Statement of the Problem Inherent shortcomings of traditional reporting have prompted development of voluntary disclosure models. Transparency and disclosure creates and sustains confidence of investors, stakeholders and the winder society and provides opportunity for continuous improvement of business structure and processes.

Corporate governance is currently an area broadly being researched on by many scholars, due to increased application of corporate governance practices all over the world after major corporate scandals due to lack or improper disclosure. This study targets one pillar of corporate governance on the cost of equity capital, which is voluntary disclosure.

Disclosed information provides a signal with an aim of revealing the state of a company to the investors for consideration in investment activities. Information has important and vital role, information should be understandable, complete, accurate, timely and reliable (Fahdiansyah, 2013).

Information is considered informative if it is relevant and can change stakeholder's belief and gives confidence to investors. Annual reports are important tools in communicating essential information about a company both financial and non financial information (Barako, 2007). The key drivers of corporate value in critical areas of the business are not reported under the traditional accounting model, as such theorist and researchers have begun to develop models for additional voluntary information disclosure.

The concept of voluntary disclosure has been growing given the needs to keep with the clients expectations. Investors and clients have challenged companies on the need to provide more than what is required by the law and regulations. In Kenya, investors obtain essential information regarding trading activities of listed companies in NSE through their annual reports and other bulletins from CMA.

Studies done in Kenya context include a study Mwangi and Mwiti (2015) investigated the impact of voluntary disclosure on stock performance, Mutiva (2015) examined the effect of voluntary disclosures on financial performance of firms quoted at NSE, Lopokoiyit (2012) investigated the effect of the corporate governance practices on share prices of companies listed at the NSE, these studies found a direct relationship between voluntary disclosure and company performance.

Study by Asava (2013) investigated the effect of voluntary disclosure on stock returns of listed companies, her study reveals that there was no correlation between voluntary disclosure and stock returns. Barako (2007) in his study of determinants of voluntary disclosure in Kenyan listed company's' annual reports, observed that companies cannot link their board disclosure, foreign ownership and firm size significantly affect financial performance.

Studies by Diamond and Verrecchia (1991), Botoan (1997), Hail (2002), Botosan and Plumlee (2002), Richard and welker (2001) and Lopes and Alencar (2008), shows a negative association between voluntary disclosure and the cost of equity capital using direct approach. However these studies were done in developed economies with few studies done in the context of developing nations, these studies tested the association between voluntary disclosure and several aspects such as profitability (Verracchia and Webber, 2006) stock liquidity.

However most of these literatures are leaning more on factors that influence the extent of voluntary disclosure. Literatures from previous studies conducted locally have skewed more to factors that influence extent of voluntary disclosures with few on the effect of voluntary disclosure on the cost of equity capital on firms listed in NSE, themotivationof this research is developed by the fact that majority of past research have given conflicting arguments creating a dilemma that necessitates further research on the effect of voluntary disclosure on the cost of equity capital of firms in Kenya.

1. 6 Objective of the study The general objective of this study is to examine the effects of voluntary disclosure on the cost of equity of capital. The following are the specific objectives. i). To examine the effect of forward-looking information voluntary disclosure on the cost of equity capital. ii). To determine the effect of financial information voluntary disclosure on the cost of equity capital. iii). To evaluate the effect of corporate social responsibility information voluntary disclosure on the cost of equity capital. iv). To establish the effect of Board information voluntary disclosure on the cost of equity capital.

1. 7 Research question The study will be guided by the following research questions. i. What if the effect of forward-looking information disclosure on the cost of equity capital? ii. What is the effect of financial information disclosure on the cost of equity capital? iii. What is the effect of Corporate Social Responsibility information disclosure on the cost of equity capital? iv. What is the effect of Board Size information disclosure on the cost of equity capital?

1. 8 Significance of the study Voluntary disclosures provide an extra way for investors to judge a company's performance. This study will therefore enable the investors to make better investment decisions and better capital allocations. It will also emphasize on increased transparency which reduces information asymmetry that may exist between the investors and the management team. This study will likewise extend the literature on voluntary disclosure to academicians.

The study will also help listed and unlisted companies in Kenya in understanding the role of voluntary disclosure in the management of their firms with aim to reduce cost of its equity capital.

## CHAPTER TWO LITERATURE REVIEW

2. 1 IntroductionsThis chapter introduces theories that explain the subject of voluntary disclosure and past empirical studies relating to the variables under the study. 2. 2 Theoretical ReviewReporting and disclosure are the most important tools that companies use to communicate with interest-related parties. Several theories have been documented to relate voluntary disclosure.

They are Agency theory, Capital Need theory, Signaling theory and Stakeholder theory. Literature review presents theories about the subject of voluntary disclosure.

2. 2. 1 Agency TheoryAgency theory was developed by Jensen and Meckling in 1976 who defined agency relationship as a contract under which one or more persons delegate decision making authority to another person to perform some services on their behalf. Agency theory explores the relationship between a principal and an agent.

In the context of a company, the manager (agent) acts on behalf of the shareholder (Principal). Company owners empower managers to make decisions on their behalf. Shareholders do not actively participate in the management of their investments instead they engage managers to act on their behalf. This makes managers have information advantage hence creating incentive to maximize their own value as opposed to that of the shareholders.

Scott (2012) stated that the application of agency theory is used to explain the conflict of interest between managers and investors. The agency problem arises due to conflict of interest between the investors and management because theirgoalsare not in agreement. Agency theory is concerned with solving two problems arising in the agency relationship: an agency problem arises when there is a conflict between the goals of the principal and that of the agent making it difficult for the principal to accurately evaluate and determine the value of decision made by the agent.

Secondly problem of risk sharing arising from diverse attitude of the principal and the agent towards risk, the problem is each tends to select a different action when the risk happens (Depoers, 2000). One way in which agency problem can be minimized is by means of contract, it helps in bringing shareholders interest in line with managers' interests (Healy and Palepu, 2001). These contracts require management to disclose relevant information to investors and to creditors.

Consequently principal can check if the management complied with the contract agreements and evaluate if their decisions are in alliance with their interest, monitoring managers by mean of contract comes with a cost at the expense of manager's compensation and in order to reduce any potential conflict, principals incur monitoring costs while agents incur bonding costs which guarantees the interest of the principal is prioritized. Agency costs are the total of monitoring costs, bonding costs and residual loss. According to agency theory, disclosing information voluntary is viewed as a better mechanism of mitigating the agency problem between the agents and principals (Hawashe, 2014).

Managers who posses private information about a firm are able to use their information they posses to make credible and reliablecommunicationto interested parties to optimize the value of the firm (Barako, 2007), these disclosure may include investment opportunity and financing policy of a company, however managers who pursue their own interest may fail to make proper information disclosure.

Managers increases the level of voluntary information which is expected to reduce the agency cost (Barako et al., 2006) and also to convince the external users that managers are acting in an optimal way (Watson et al., 2002). OCED (2004) states that a strong disclosure policy is one of the expected monitoring forms that is useful as a basis of adequate information for investment decision making by investors.

2. 2. 2 Capital Need TheoryThe main aim any company is to attract externalfinanceto increase their capital either through debt or equity, however companies are disclosing more information voluntary as a measures of minimizing costs of raising its capital. The capital need theory can help to explain the reasons behind the disclosure