

# Chapter 5

## Voluntary Disclosures

### 5.1 Introduction

Disclosures are a way of communicating information to the various stakeholders. Law can regulate these disclosures or the management can give them voluntarily. Over the years business environment has become complicated and complex and the mandatory disclosures have not kept pace with these changes. Disclosure of items such as intangibles have become important especially to knowledge-based companies. While the accounting standards relating to intangibles specify certain disclosures, they are not comprehensive for the stakeholders. Some of the self-generated intangibles like brands are not recognised in the financial statement and hence the standard setting authority can impose additional disclosures outside the financial statements.<sup>265</sup>

Even in the absence of disclosure requirements, firms will have greater incentive to move towards better or higher disclosure standards.<sup>266</sup> Management may give some of the non-mandated disclosures voluntarily to the stakeholders so that firms may be valued better. Some researchers also argue that discretionary disclosures by management may be self-serving for a particular purpose. For example, a study by Murphy and Zimmerman, of proxy statements, suggests that managers may exercise discretion in the production and disclosure of accounting information to cover up or conceal poor performance both by their firms and themselves.<sup>267</sup> Another study using the same proxy statements, interpreted their results as indicative of self-serving behaviour of information disclosure on the part of the firms' management.<sup>268</sup> Moreover, these voluntary

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<sup>265</sup> W.H. Beaver "What should be the FASB's Objectives?", 135(3) *Journal of Accountancy*, 49-56 (1973)

<sup>266</sup> S. Huddart, J.S. Huges and M. Brunnermeier, "Disclosure Requirements and Stock Exchange Listing Choice in An International Context", 26 (2) *Journal of Accounting and Economics* 237-269 (1999); Verrecchia argues that if firms did not disclose they may be denied access to capital markets, R.E. Verrecchia, "Disclosure and the Cost of Capital: A Discussion", 26 (2) *Journal of Accounting and Economics* 282, 271-283 (1999)

<sup>267</sup> K.J. Murphy and J.L. Zimmerman, "Financial Performance Surrounding CEO Turnover", 16(1-3) *Journal of Accounting and Economics* 273, 273-315. (1993)

<sup>268</sup> W.G. Lewellen, T. Park, B.T. Ro, "Self-serving Behavior In Managers' Discretionary Information Disclosure Decisions", 21(2) *Journal of Accounting and Economics* 227- 250 (1996)

disclosures may be vague and unverifiable without committing to any precise information.

While full disclosures are most desirable, having to mandate them would involve additional costs including losing the competitive advantage that the company may have. The study of voluntary practices by companies will give additional inputs to regulators to mandate certain information that will enhance the usefulness of the annual report. This may also set an example to others to give more information. In this chapter, the corporate voluntary disclosures are measured and factors affecting them are discussed. The effectiveness of the annual report for the individual shareholder is also surveyed.

The remainder of the chapter is as follows; Section 5.2 examines the prior studies in measurement of disclosures. Section 5.3 gives the sample selection. Construction of the disclosure index and importance of the items are discussed in Section 5.4 The results of the disclosure index is discussed in Section 5.5 Factors or attributes affecting the voluntary disclosure practices are discussed in Section 5.6 Descriptive statistics and the regression results are discussed in Sections 5.7 and 5.8 respectively. Section 5.9 discusses the investor's perception and effectiveness of the annual report and the final section gives suggestions for improvement.

## **5.2 Measurement of Disclosures**

The voluntary disclosures made by companies are sometimes descriptive in nature, but they must satisfy the basic constructs of adequacy, informativeness, timeliness and comprehensiveness. Each of the above characteristics is a proxy for disclosure and is referred to as a standard of disclosure excellence, which can be measured from poor to excellent.<sup>269</sup>

Imhoff defines disclosure quality as "an evaluators overall subjective assessment of the relevance, reliability and comparability of the accounting data produced by the reporting entity.... in essence, the relative usefulness of the

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<sup>269</sup> R. S. O. Wallace and K. Nasser, "Firm-Specific Determinants of Comprehensiveness of Mandatory Disclosure in the Corporate Annual Reports on the Stock Exchange of Hong Kong", 14 (4) *Accounting and Business Research* (1995) at 327

data and the analysis based on the data."<sup>270</sup>

The quality of disclosures can thus mean more details on each information item of interest without causing an information overload. In a way, it implies that presentation of minimum amount of information in the corporate report sufficient to permit a reasonable evaluation of the relative merit and risks of listed securities.<sup>271</sup> In this study, both the voluntary and voluntary related to mandatory disclosures are covered.

The quality of disclosures in this research is measured by construction of disclosures index. The construction of the disclosure index is based on two procedures; i) Disclosure measures in prior research ii) Review of current developments in reporting standards.

The disclosure index provides a reasonable method for measuring the overall disclosure quality of a firm. Prior research in this area has made extensive use of index as a research method.<sup>272</sup> Disclosure index involves the development of an extensive list of disclosure items, which are expected to be relevant to the users of information. Disclosures to the market participants can be made through annual reports, quarterly reports and continuous disclosures to the stock exchanges. In this research, only the annual report information is used for constructing the index. Earlier studies have even used interim reports and conference calls to measure voluntary disclosure. In order to scrutinise types of information, which are important, this research has reviewed previous studies that use disclosure indices and literature on reporting standards and practices adopted voluntarily by companies.

### **Disclosure measures in prior research**

A review of the existing literature is undertaken to enhance the understanding and identifying the factors that influence reporting decisions such as firm characteristics, market response to the disclosures and the firms specific

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<sup>270</sup> E. A. Imhoff, "The Relation Between Perceived Accounting Quality and Economic Characteristics of the Firm", 11(2) *Journal of Accounting and Public Policy* 97-118 (1992)

<sup>271</sup> C.H. Griffin and T. H. Williams, "Measuring Adequate Disclosure", 109(4) *Journal of Accountancy* 43-48 (1960)

<sup>272</sup> C. L. Marston and P.J. Shrides, "The Use Of Disclosure Indices in Accounting Research: A Review Article", 23(2) *British Accounting Review* 195-219(1991) See also C.L Marston and P.J. Shrides, "A Review of the Development and Use of Explanatory Models in Financial Disclosure Studies", *Working paper, EEA Bergen (1996)*

incentives for disclosures and also to understand the method used for measuring disclosure. Prior studies on disclosure have been broadly classified as those on disclosure indices, event studies and specific disclosure analysis. Studies have used the method of computing disclosure index for determining the level of disclosures. The method adopted for constructing the disclosure index can be of two types; use of the published disclosure index or to have a self-constructed disclosure index.

Cerf's study was the earliest study conducted for measuring the disclosure through an index about forty years ago.<sup>273</sup> Cerf reviewed the annual reports of 258 New York Stock Exchange listed firms, 113 firms listed on other exchanges, and 156 OTC firms over the period between July 1956-June 1957. Regression analysis was performed on 31 weighted items. The items in the index were assigned weights between 1 and 4. The study found a positive correlation between disclosure, asset size, number of stockholders, and profitability. A Study by Singhvi & Desai on disclosure practices used 34 items in the index and used different weights. Their sample consisted of 100 listed and 55 unlisted companies from the New York Stock Exchange and the Over the Counter Exchange (OTC). They reported that firms disclosing inadequate information were small firms and were less profitable.<sup>274</sup>

Buzby analysed the annual reports of 44 New York Stock Exchange and 44 OTC firms, over a period of one year between 1970-1971. The index constructed in the study was arrived at, based on the information needs of the analysts. The index consisted of 38 items and was weighted. Questionnaires were administered to arrive at the weights. The selection of the items of disclosure was based on the criteria specific to the industry that was selected. These items varied in terms of presentation in the annual report and were applicable to all the firms. A maximum score was computed. A ratio of the firms score to the total score was computed which formed the index.<sup>275</sup>

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<sup>273</sup> A. R. Cerf, *Corporate Reporting and Investment Decisions* (Berkeley, University of California Press, 1961)

<sup>274</sup>S. S. Singhvi, and H. B Desai, "An Empirical Analysis of the Quality of Corporate Financial Disclosure", 46 (1) *The Accounting Review* 129-138 (1971)

<sup>275</sup>S. L. Buzby, "Selected Items of Information and Their Disclosure in Annual Reports", 49(3) *The Accounting Review* 423-435 (1974).

Choi investigated the annual reports of 72 firms, which raised capital in the European Markets. The study used matched pairs to examine 36 un-weighted and weighted disclosure items. The items in the index were arrived from the investor's perspective and from prior literature. The study found that entry to the European capital market is related to improvements in disclosure.<sup>276</sup>

Index studies in international settings indicate how disclosure reflects a firm's disclosure characteristics. In the country comparison, Barrett studied the annual reports of 103 firms, located in France, Germany, Japan, Sweden, the Netherlands, the UK and the United States. There were seventeen items both weighted and un-weighted. The study found that the overall extent and quality of American annual report disclosure is not better than that of British firms. The study found that in specific disclosure areas, there are differences among countries. The study also proved that the quality of disclosure and the degree of efficiency of national markets are positively related.<sup>277</sup>

Nair and Frank, examine 233 accounting principles and reporting practices of 38 countries in 1973 and 264 principles and practices in 46 countries in 1975. Factor analysis and discriminant analysis were performed on 6 classification categories for principles and practices in 1973 and 7 classification categories for principles and practices in 1975. The groupings of countries by disclosure practices were different from groupings based on measurement practices. Also, the underlying environmental variables most closely associated with the practices were different. The results had implications about the comparability of financial statements and accounting harmonisation.<sup>278</sup>

McNally, Eng, and Hasseldine studied the annual reports of companies listed on the New Zealand Stock Exchange. The sample size consisted of 103 firms. The study used 41 weighted items. The items were based on the study of literature and the latest annual reports. These items were pilot-tested on stockbrokers. The results found that stockbrokers and financial editors perceived the voluntary disclosure of a wide variety of items of information to be important.

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<sup>276</sup> F.D.S. Choi, "Financial Disclosure and Entry to the European Capital Market", 11(1) *Journal of Accounting Research* 159-175 (1973)

<sup>277</sup> M. E. Barrett. "Annual Report Disclosure: Are American Reports Superior?", 6(2) *Journal of International Business Studies* 15-24 (1975)

There was deviation between actual disclosure and the degree of disclosure perceived to be desirable by external users. The study also found that the size of a firm was positively related to voluntary disclosure.<sup>279</sup>

Meek et al., studied the voluntary disclosures from the international perspective. Their study examined the factors influencing the voluntary disclosures of three types of information: strategic, non-financial and financial information contained in the annual report. The sample of the study consisted of 64 UK, 116 US, 16 firms from France, 12 firms from Germany and 18 firms from Netherlands (together referred in the paper as Continental European countries). Their study revealed that, company size; country or region and the listing status were very important factors explaining the voluntary disclosures. The industry groupings were influencing only to a certain extent. Disclosures of strategic information reflected the international listing status. The study also concludes that Continental European countries made more voluntary disclosures than that of the American and British companies to overcome the conservative practices in these countries and any disadvantage they may have because of this. Voluntary non-financial information was also higher in the Continental European countries.<sup>280</sup>

Cooke analysed disclosure in Swedish firms. The sample consisted of 38 unlisted, 33 listed firms on the Swedish Stock Exchange, and 19 firms listed on both the Swedish and at least one foreign stock exchange during the year 1985. The disclosure index consisted of 146 un-weighted items. Regression analysis was performed and the results indicated that listing status and size were major explanatory variables for voluntary disclosure. In addition, firms categorised as 'trading' disclosed less voluntary information than other industries.<sup>281</sup> Study by Nasser and Nuseibah examined the voluntary disclosures, mandatory disclosures and voluntary related to mandatory disclosures of firms listed in

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<sup>278</sup> R.D. Nair and W.G. Frank, "The Impact of Disclosure and Measurement Practices on International Accounting Classifications", 55 (3) *The Accounting Review* 426-450 (1980).

<sup>279</sup> G.M. McNally, L.H. Eng and C.R. Hasseldine, "Corporate Financial Reporting in New Zealand: An Analysis of User Preferences, Corporate Characteristics and Disclosure Practices for Discretionary Information", 13(38) *Accounting and Business Research*, 11-20 (1982).

<sup>280</sup> G.K. Meek, C.B. Roberts and S.J. Gray, "Factors Influencing Voluntary Annual Report Disclosures by US, UK and Continental European Multinational Corporation", 26 (3) *Journal of International Business Studies*, 555, 555-572 (1995)

Saudi Arabia. They concluded that the level of voluntary disclosures were low, although firms reported more than that required by law.<sup>282</sup> Chau and Gray, examined the voluntary disclosures of firms in Singapore and Hong Kong using the disclosure index constructed by Meek and Roberts and tested the association of ownership structure on the voluntary disclosures. Hong Kong and Singapore listed companies are usually controlled by family firms and hence have no motivation for voluntary disclosures. They hypothesised that there was a positive association between the wider ownerships structure and the extents of voluntary disclosures. Their result supported the view of agency theory based hypothesis.<sup>283</sup>

The information focused in prior research included both financial and non-financial information. Some of the non-financial information consisted of employee information, the value added reports, using of graphs, the reporting of social responsibility information. Trotman and Bradley considered social responsibility information disclosed in the annual reports. Their results suggested that companies that provide information on social responsibility was normally large in size, have a high systematic risk and place stronger emphasis on its long-term objectives.<sup>284</sup>

Research on voluntary disclosures used both self-constructed disclosure index and published indices. In the US, many of the studies used the Association for Investment Management and Research (AIMR) ratings. In India, there is no such data readily available, hence data collection is a tedious process. Most of the studies on voluntary disclosures focused only on the developed countries like the USA, the UK and very few studies published include Indian data.

Prior studies in India have also used the disclosure indices. Lal, examined the relation between the earnings margin, nature of industry, business groups, asset size and the level of disclosures of Indian Companies. The study found

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<sup>281</sup> T.E.Cooke, "Voluntary Corporate Disclosure by Swedish companies", 1(2) *Journal of International Financial Management and Accounting* 1-25 (1989)

<sup>282</sup> K. Naser and R. Nuseibah, "Quality of Financial Reporting: Evidence from Listed Saudi Non Financial Companies", 38(1) *The International Journal of Accounting* 41-69 (2003)

<sup>283</sup> G K Chau, and S. J. Gray, "Ownership Structure And Corporate Voluntary Disclosure in Hong Kong and Singapore", 37(2) *The International Journal of Accounting* 247-265 (2002)

<sup>284</sup> Trotman, K. T. and Bradley, G. W. "Associations Between Social Responsibility Disclosure and Characteristics of Companies", 6(4) *Accounting, Organizations and Society* 355-362 (1981)

that Indian companies did not disclose many items voluntarily.<sup>285</sup> The study by Pradhan found that companies were disclosing only what was statutory. However, over a period, the non-statutory disclosures did increase.<sup>286</sup> A study by B. Rathinam found that disclosures in the annual report of Indian firms was related positively the profitability, turnover, asset size and collaborations.<sup>287</sup> ICAI Research Committee study found that public sector firms disclosed more information than private sector companies, however there was no uniformity in the presentation of the various information.<sup>288</sup> A probable reason is that certain disclosures are mandatory for public sector companies.

This research study constructs the disclosure index for Indian companies to measure the standards of disclosure practices. In the next section the sample selection and the variables are defined.

### 5.3 Sample Selection

The sample for this dissertation was selected from the BSE 100 (index) companies. From this sample, banking and finance companies were eliminated as the disclosure requirement for these companies are specialised and regulated by other regulatory authorities. Appendix 6 gives the list of 86 companies selected as the sample. The sample companies include companies from different industries viz: Information Technology (18%), Pharmaceutical and Chemical companies (20%), Fast moving consumer goods sector(10%), Cement Steel and Fertiliser (12%), Automobile (15%) including two wheeler and tractors and others (25%).

The sample consists of public sector companies (16%), multinational ownership (22%) and others with dominant Indian ownership (62%). The number of listed companies in India was more than 5000 as on March 2002. The sample companies are large and accounted for nearly 70 % of the market capitalisation in the Bombay Stock Exchange. Apart from having representation from different

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<sup>285</sup> J. Lal, "The Quality of Corporate Financial Disclosure", 23(9) *The Management Accountant*, 591, 593 (1982)

<sup>286</sup> P.B. Pradhan, "Corporate Financial Reporting Practices in India", 20 (4) *The Chartered Secretary*, 692-695 (1987)

<sup>287</sup> B. Rathinam, *Corporate Disclosure Practices in India, Unpublished Dissertation* (University of Madras, 1989)

industries these firms have other features such as, listing in foreign stock exchanges and audit by big auditing companies.

Annual reports of companies were collected from various sources. This included writing to the companies for their printed annual reports. Some annual reports were also downloaded from data source: [www.insightasianerc.com](http://www.insightasianerc.com). Companies website were also accessed for annual reports. The year taken for the study is the financial year ending 2002, which was the latest at the time of the study. This year is also significant in some respects, as certain items of disclosures were mandated by listing agreement and the accounting standards, for the first time requiring extensive disclosure in the annual report.

## 5.4 Construction of the Disclosure Index

The disclosure index in this study provides a measure of company's voluntary disclosure in the annual report. While the companies will report what ever is mandatory, the quality of the disclosures will be determined by the comprehensiveness or informativeness of these disclosures and disclosures beyond the legal requirements are also examined.

The disclosure checklist used in this study is arrived at through various processes. The annual reports of companies were studied and differences were observed in the levels of information disclosed, which provided an important base for identifying the items of the index.

In order to improve the business reporting, several committees and research studies were undertaken all over the world. The important ones are, The AICPA Special Committee Report and the FASB Steering Committee report, which is considered as an extension of the Special committee report and have recommended many of these items to be included in the annual report.<sup>289</sup> The index reflects many of these items.

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<sup>288</sup> ICAI Research Committee Report, *Trends in Published Account* (New Delhi :Institute of Chartered Accountants of India, 1985)

<sup>289</sup> AICPA, *Improving Business Reporting – A Customer Focus, Comprehensive Report of the Special Committee of the Financial Reporting* (New York: AICPA, 1994) referred as the Special Committee Reporting this research and FASB Steering Committee report, *Improving business Reporting Insights into enhancing voluntary disclosures* [www.fasb.org/brrp/brrp1.shtml](http://www.fasb.org/brrp/brrp1.shtml) referred as FASB Report. The Canadian Institute of Chartered Accountants study as another such study.

Disclosure checklist of prior studies was also examined. Disclosure list used in the study by Meek et al was also used extensively in this study.<sup>290</sup> The number of voluntary disclosure items in the disclosure list of the Meek et al study was higher than the other studies discussed in the earlier section. Meek et al also made a comprehensive study of various other research works, trends and reporting practices to arrive at the final disclosure list. The disclosure list covered a variety of items and was broadly classified as strategic information, financial information and non-financial information that are important for the investors and that are important from the long-term prospects of the company. Their disclosure index consisted of 85 items. These items were then compared with the mandatory disclosures prescribed in India. For example, the list of items included 'Stock price information' including market capitalisation at the year-end, as these information are mandatory in the corporate governance section and hence they are excluded from the list. Similarly, segment information relating to line of business production was eliminated, as this is mandatory. A few other items were included to capture the comprehensiveness of the disclosures. After a process of elimination/addition, 72 items were included in the disclosure index. Two academicians also reviewed these items. The list of items is given in the Appendix 7.

The contents of the disclosure index are broadly categorised into strategic information, non-financial information and financial information. Further divided into various groups such as:

Strategic Information: 1) General corporate information 2) Corporate strategy and objectives 3) Acquisitions and disposal 4) Research and development and 5) Future prospects information.

Non-financial information: 1) Information about the Board of Directors 2) Employee information 3) Social Policy and 4) Other information

Financial information: 1) Competitor and Market share Analysis 2) Financial review information.

Some of these are mandated in the Form 10 K in the US. The sub categories were then grouped into three main categories as Strategic

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The Canadian Institute of Chartered Accountants, *Information to be Included in the Annual Report to the Shareholder* (Canada: CICA 1991)

<sup>290</sup> Meek et al see Supra note 108 at 555 - 572

Information, Non-financial Information and Financial Information. The purpose for such a classification is necessary due to the differences in the nature of information and the predominant user group that may use them and also to give insights into the kind of information that a firm may disclose.

Items listed in the index are disclosed in the various sections of the annual report such as the Directors Report, MDA and sections before the financial statements or even in the chairman's speech. A few of this information are also available through other sources of communication by the companies and from sources such as the industry reports, communication through the press. Certain information is required to be filed with the Registrar of Companies. However, for this study, only the annual reports are considered because of its general nature as a comprehensive document and the user of the report must get all information about the company in one document.

#### **5.4.1 Items included in the Disclosure index**

The disclosure list is constructed to capture the intensity of the mandatory disclosures as well as disclosures that are not required by law. The selection of these items in the index was based on earlier studies and also as a result of the difference observed in the levels of disclosures by companies. The basis for including these items in the index is explained next.

##### **1. Strategic Information**

Users of financial information need to understand the type of business and the broad strategy adopted by the company. They also need to know the relation between the various activities of the company and the events that took place during the year and the effects of such events on the results of the company. The stakeholders will not be able to assess the risks and opportunities of a business or a company, which they do not understand or cannot link.<sup>291</sup> The need for strategic information stems from the need to understand the business

##### **General Corporate information**

The corporate strategic information contains the general information about the company and the objectives of the organisation. The general information

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<sup>291</sup> Supra note 289 at 22

about the company is a brief history of the company and the organisation structure of the company. For any investor, the annual report is a comprehensive document that should give all the information at one place. The brief historical development of the company will help the investor get the background information for understanding the company. The background information would include information like the year of incorporation, the sector in which it operates and such other details relating to the past. The corporate profile information is essential to the users and should be provided in the annual report in view of the different risks, prospects and other requirements from one industry to another.<sup>292</sup> This information is voluntary and is not required by the Companies Act. Brief history of the company is mandatory in the Form 10 K in the US.

### Organisation Structure

Information on the organisational structure complements the general information. This information identifies the organisational units of the company together with their geographical locations. The organisation structure giving the management team and their details will give insights into the quality of the employees (top management) of the company. Details of the structure will also help in understanding the decision making process of the company and also level of concentration of power in the company. The critical importance of people like the senior management is essential for the overall success of the business and this can be depicted in an organisation chart.

### Corporate Strategy and Objectives

Information about the corporate strategy and objectives in various areas is useful in understanding the broad goals of the company. As given in the Special committee report, "this information will help provide forward looking perspective about where the management intends to lead a company."<sup>293</sup> Knowing the objectives of a company will also help the user in evaluating the performance against those objectives. In a way it will also indicate the company's ability to meet challenges and face the competition. The corporate strategic information consists of the company's general objectives, marketing and financial objectives,

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<sup>292</sup> The Canadian Institute of Chartered Accountants, *Information To Be Included in the Annual Report to the Shareholder* (Canada: Canadian Institute of Chartered Accountants, 1991) at 77

<sup>293</sup> Supra note 289 at 31

usually, these are in the form of a mission statement or an outline of plans. The corporate statement of social objectives is also included under this classification. The impact of various strategies on the current and future results of the company is also important information for the investor.

The Special Committee report states that such information usually includes a forward-looking perspective about the direction of the company's future. Some of these statements may be competition sensitive information and hence companies may disclose only a broad statement without going into details. Although these may be general in nature, they will still be useful in evaluating the management and its future prospects. Sometimes companies may not disclose this information, as they may not have established formal strategies or objectives. In some cases, the strategies may be difficult to communicate.

#### Strategic Acquisitions, Investments and Disposal

Companies may acquire and dispose divisions/companies for strategic reasons and for synergy in operations. While companies may just give the information about the acquisition and disposal, giving reasons of such an action must also be communicated to the stakeholders for understanding management's plan for achieving earnings growth. It is also helpful to know the strategic investments of the existing businesses and whether it can provide satisfactory growth, and the extent to which acquisition or disposal may be necessary to achieve corporate goals.

Different industries have different capital investments needs. Some industries, depending on their growth stage, may need huge investments. Strategic investments in major projects, encompassing modernisation plans, acquisition, expansion, divestiture, and restructuring plans are useful information considered by analysts. This information will also be helpful in assessing the capital or financial needs of the companies. The effects of such actions are also used in forecasting future performance. Major expenditures on plant, property and equipment are evaluated, particularly in terms of product costing and capacity expansion. Strategic acquisition and disclosures thereon are given in Table 4.2 of Chapter 4. The information indicates the levels of disclosures by companies mandated through the accounting standards.

## Research and Development

Research and development is an important area of disclosures that will indicate the future prospects of many companies especially in the pharmaceutical industry. Acknowledging this importance, it is mandatory for companies to give the Research and development expenses as part of the Directors Report. Specific research and development activities that are carried out by the company, the benefits derived as a result of the Research and development activity and the future plan of action are mandatory and covered in the Director's report. Substantial information has been covered by the mandatory disclosures. The Special Committee on reporting recognises the importance and at the same time acknowledges the competition-sensitive nature of this information. Information on product development activities is also valuable to the markets. The Special committee stated that such information may help the competitors development and introduction of product plans which may affect the company's' market position. Competitors are always on the look out for such information.<sup>294</sup>

## Future Prospects

Investors need information about the future prospects of a company apart from the past information. Forward looking information or future prospects type of information comprises of forecasts, projections, and certain pro-forma presentations for sales, profits, cash flows, and measurements of uncertainties and risks. These numbers are of great importance to analysts, but they are not part of the economic history of the firm and therefore not proper financial statement components. Nor are they auditable, although the participation of an independent accountant in their preparation could enhance their credibility and "user-friendliness" as well as provide some assurance that management's methodology was sound, its assumptions reasonable, and its calculations accurate. The legal environment in countries like US discourages companies from disclosing forward looking information because of fear of litigation, at the same time, companies are constantly threatened by the short term

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<sup>294</sup> In a survey by Mautz and May it was reported that the companies have high interest and tracked the product development projects of competitors. R.Mautz and W May, *Financial Disclosure in a Competitive Economy* (New York, Financial Executives Research Foundation, 1978)

repercussions on the stock prices for non-disclosures. There is also a safe harbour clause for such disclosures. Good corporate governance calls for an unbiased reporting at both good and bad periods.

Forward-looking information requires a lot of judgement and unforeseen changes in circumstances may change the underlying assumptions. This may render the forecast inaccurate. Hence, most companies in India only give a general statement. As stated in the special committee report, forecasts help the user to understand the management's view of the future and plans for the company. In a way, it will also act as disciplining tool and make management develop plans and look into its implications on performance.

The MDA section of the annual report contains the future outlook statements, opportunities and threats, risks and concerns, but the contents are left to the discretion of the companies. The forecast statements can be clearly expressed in terms of numbers or can be non numerical but should be more than general statements if they have to be useful to the investors. Positive as well as negative aspects on performance have to be discussed in a balanced way.

Information about the risks and concerns are required to be discussed in the MDA. Information about the risks a company faces and the risk management measures put in place is very useful information for the investor. Companies may face different types of risks based on their operations. Risks could be in the nature of financial risk, market risk, business concentration risk etc. These risks may vary depending on the industry.

## **2. Non-Financial Information**

Defining the role of non financial information the King II Report states: "Corporate citizenship is the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life."<sup>295</sup>

Organisations work in the society using resources of men and material from them. There is social contract that exists between the firm and the society

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<sup>295</sup> Institute of Directors, "Executive Summary of the King II Report" The King Report on Corporate Governance of South Africa , 2001 [www. www.ecgi.de/codes/country\\_documents/south\\_africa/executive\\_summary.pdf](http://www.ecgi.de/codes/country_documents/south_africa/executive_summary.pdf) (Nov 11,2003)

within which that firm operates and consumes resources. Any social institution and even business operates in a society via a social contract, expressed or implied. Their survival and growth are based on the delivery of some social desirable ends to society in general and the distribution of economic and other benefits to groups from which it derives its power.

The non-financial information includes information about Directors, employee related information, and corporate social policy and environment statements and information about the safety of the products and value added statements. The importance of including them in the index is discussed below.

#### Information about the Board of Directors

Information about the Board of Directors is necessary as knowing the people who are at the helm of affairs will enhance the investors confidence in the company. The information regarding Directors should contain the age, experience, other Directorship and the education qualifications. At present these information needs to be given only on appointment or reappointment of the non-executive Directors.

#### Employee Information

Employees are key resources for the successful functioning of an organisation. Information about employees should contain information on training, career planning, distribution of employees segment wise, safety measures implemented by the company the recruitment policy etc. Employee information is useful indicator of future prospects of the company. For example, training information may give some clues as to the company's future plans, as well as the managements commitment to supporting employee and their growth. Disclosure of human resource intangible assets is important to the firm's future and thus useful for the investors in decision-making. Safety policy and safety measures undertaken by the company also gives additional information

The performance of the company in a way depends on the important resource i.e. its employees. Their performance depends on the qualification, experience, the training given and the remuneration package offered and other measures taken by the company. Employee information is particularly relevant to the knowledge-based industries like the software industry as its success and economic prospects depends on the manpower and in retaining them. The

Special Committee Report recommends background information of the executive management and the number of employees to be reported. Redundancy, recruitment policies are other information considered important. Certain information on employees while being useful may be sensitive and provide information to headhunters. The number of employees' and the material development in the human resources information are mandated in the MDA.

### Social Policy Statements

An important area of disclosure is the corporate social policy or responsibility statement. The key success factor in the long term for any company (more pronounced in the developed countries) is the public view of the products and services that it produces. Public attitude may be influenced by the community work the company does in different areas. Reporting of social responsibility statements and activities are at present considered most important for a sustainable growth

A company's involvement in the community programs such as development of community education, social service in health and environment protection program adopted by it are important areas of disclosures. For example, many chemical and fertiliser companies ignore the harmful effects of their processes on the environment. Information on environment must include the impact of production processes, products and services on air, water, land, biodiversity, and human health. Manufacturing, oil and energy companies, which have clear ramifications on natural resources should provide this information. The increased demand in environmental disclosures has corresponded with an increase in community concern regarding environmental matters like in the developed countries. For a company, society's expectations of corporate behaviour are both implicit and explicit.<sup>296</sup>

### Value added statement

EVA (Economic Value added) is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk. Value added statements give superior information to the

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<sup>296</sup> C.Deegan and B.Gordon, "Study of The Environmental Disclosure Policies of Australian Corporations", 26(3) *Accounting and Business Research* 187-199 (1996)

investors as a performance measure. It serves as a tool for strategy implementation process linked to various functions of the organisation.<sup>297</sup> In particular, 'economic value added' statements give a better measure of performance than market based performance.<sup>298</sup> Companies would normally give this information only when there is positive value addition.

Other non-financial information is the Government policy effects on sales and discussion on litigation are included in the index as they may affect the working of the company.

### **3. Financial Information**

Financial information can be broadly classified into competitor analysis and the financial review. The competitor analysis gives additional information to the discussion in the MDA. The results of the financial performance are part of the Director's report, however they do not contain additional information needed to understand the results of the company. MDA report has improved upon the Director's report by including a discussion on the financial performance. Yet, managements have great discretion in disclosing information. A review of operating results describes the significant features of operating performance for the financial period. It should discuss the performance of the main business segments and their impact on the group results overall, with comment on both successes and failures. Investors seeking to understand future results are particularly interested in the trends from year to year.

The review of financial information ideally may include: the ratio analysis, discussion on liquidity, the dividend policy, changes in the business environment including any governmental, economic, and other factors that materially affect the operations. Significant components of revenues or expenses should be described in order to appreciate the operating results. Some companies merely give the numerical changes from year to year, which are readily computable from the financial statements (Although giving the reference makes comparison easier) and the same is repeated at both the MDA and in the Director's report.

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<sup>297</sup> S.D.Young and S.F. O' Byrne, *EVA and Value Based Management* (New York, McGraw Hill Company, 2001) at 19

Government company's annual report have the review of the Comptroller and Auditor General in a standard format.

The Director's report has to include a review of the financial performance of the company. While all the companies may discuss some aspects of the financial review, discussion using the financial ratios is more informative. The financial risk is portrayed largely through quantitative means, particularly by using financial ratios specially the profitability ratios, liquidity ratios, cash flow ratios and gearing ratios. Ratios are tools that will help the comparison of performance between companies and for the same company over years.

The decision making process is largely based on comparisons, so it is important to have a common frame of reference and important data for a few years. A summary of the financial historical data will give the past information at one place for easy comparison and also for a limited inference of the future working.

#### Intangibles

Self-generated intangibles are not recorded in the book of accounts. Management can account for these intangibles outside the accounting information by way of voluntary disclosures, which will enhance the usefulness of the annual report. In a knowledge based industry, know how, innovation and brands have to be build from year to year for the proper valuation and success of the company in the market place. Reporting of intangibles becomes crucial for companies where "intangibles" are of great value.

While this research tries to capture some aspects of the voluntary and voluntary related to mandatory disclosures, it is not possible to assess or verify the quality of the information provided. Similarly, the study cannot control the accuracy of disclosure and it is not meant to identify any disclosure that may be incorrect or fraudulent.

#### **5.4.2 Computation of the index**

The disclosure index is developed using the information listed in the disclosure checklist. The contents of the annual report were examined and the

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<sup>295</sup> L. Walbert, "The 1994 Stern Stewart Performance 1000", 6(4) *Journal of Applied Corporate Finance* 105 (1994) discussing Economic Value Added (EVA) ©

scoring for the voluntary disclosures is done in the form of 1 and 0. If a disclosure item is present then a score of (1) is given and if an item is not present then (0) is entered as the score. When a particular item was not applicable the score of NA was entered. The entire annual report was scrutinised carefully before giving an item 0 or NA. The scores for each company were then aggregated. The voluntary disclosure index (DISCIN) for each of the company was computed as TVD/ MVD where the TVD is the total voluntary disclosures as proportion to the MVD the maximum voluntary disclosure possible. This index is a relative index where the company's score and the total score are adjusted to the items that are not relevant. The TVD and MVD are hence adjusted for an item that is not relevant so that they are not penalised for not disclosing. For example, a company may not have any acquisitions during the year. Hence, may not be showing a disclosure on such an item. In such cases, the entire annual report specially the Director's report, the movement in investments are studied again to ensure that such an item of disclosure is not relevant for the company. The relative index has been used by many prior studies.<sup>299</sup> The dependent variable is the voluntary disclosure index computed.

The voluntary disclosure study can use both weighted and un-weighted scores for computation of the index. Assigning weights to the individual elements of a disclosure index is a difficult process. The ideal process is to obtain a set of disclosures that are important to various stakeholders and assign weights that are appropriate to the research. These weights or ranks can be arrived at by different ways. Many studies use the questionnaire method to determine the weights in the index, which were than followed by an interview. The study by Baker & Haslem sent the questionnaire to individual investors. The different users groups assigned a weight for each individual item in the disclosure index. The assigned weights specified the importance of different items for specific user groups.<sup>300</sup> The study by Firth also used the questionnaire and found that the weights given to the items in the index by the different users

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<sup>299</sup> T.E. Cooke, "Disclosure in the Corporate Annual report of Swedish Companies", 19(74) *Accounting and Business Research* 113-124 (1989) and R.S. Oluesgun Wallace, K. Nasser and A Mora, "The Relationship Between the Comprehensiveness of Corporate Annual Report and Firm Characteristics in Spain", 25(97) *Accounting and Business Research*, 41, 41-53 (1994)

<sup>300</sup> H.K. Baker and J. A. Haslem, "Information Needs of Individual Investors", 136 (5) *The Journal of Accountancy* 64-69 (1973).

were different. Analysing the results further, Firth found that finance Directors and auditors gave similar weights, which were different from the weights given by the analysts and bank loan officers.<sup>301</sup> Which means that perceived importance of each item of disclosure is different. There is subjectivity associated with giving weights that is recognised by Ashton: "Generally, individuals overestimate the extent to which they utilise the less important cues and underestimate the extent to which they utilise the more important cues, i.e., subjective weights are much more evenly distributed across cues than are statistically-derived weights."<sup>302</sup> Thus, giving weights would mean a certain degree of subjectivity and might reflect the importance of certain types of information to the specific user. Many earlier studies have also found several problems, which are well documented.<sup>303</sup> Furthermore, the annual report is a very general report, used by many people and hence, an unweighted approach is taken. Prior research has also used the unweighted approach for computation of index. These include the study by Cooke and also the study by Meek, Roberts and Gray.

The voluntary disclosure index in this dissertation uses the unweighted scoring approach. The underlying assumption is that the disclosure items in the index are of equal importance to the corporate information users. Another line of argument is that companies that are better at disclosing important items are also better at disclosing less important items.<sup>304</sup>

The measurement of disclosures may result in the researchers use of judgement i.e. there is subjectivity involved. In order to minimise any inconsistencies in measurement process, the annual report were analysed twice to ensure that the disclosures are same in both the times. At the first instance the entire report was scrutinised and coded. The second examination was to get confirmation on items that were not relevant or not present. This method has

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<sup>301</sup> M. Firth, "A study of the Consensus of The Perceived Importance of Disclosure of Individual Items in Corporate Annual Reports", 13 (Fall) *The International Journal of Accounting Education and Research* 57- 70 (1978).

<sup>302</sup> R.H. Ashton, "The Predictive-Ability Criterion and User Prediction Models" 49 (4) *The Accounting Review* 719-732 (1974).

<sup>303</sup> C. Firer and G. Mirth, "Information Disclosure in Annual Reports in South Africa", 14(5) *Omega* 373-382 (1986)

<sup>304</sup> T.E Cooke, "Disclosure in the Corporate Annual Reports of Swedish Companies", 19(74) *Accounting and Business Research* 113-124 (1989)

been suggested in prior research. One more procedure was observed for removing any judgemental errors. The annual reports were given to a member of the professional accounting body for getting independent scores. These scores were then compared with the researchers score and then consensus was arrived for deriving the final scores. The result suggests that there was substantial agreement between the independent scores and the researchers scores.<sup>305</sup> This procedure has been followed in prior research that used the disclosure indices. The overall disclosure index score is given in Appendix 8

## **5.5 Results of Voluntary Disclosure Study**

The results of the disclosure index score are given in Table 5.1. The voluntary mean disclosure score varied from 43.6 % in terms of strategic information and 19.4 % for non-financial information and 24.7 % for financial information. The overall disclosure score was 29.5 % (Mean raw score 21.2). The highest raw score achieved by a firm is 51.9 (72.1%) and the lowest being 7%. The median and standard deviation is 27.5% and 12.3% respectively. The median score of the three groups of Strategic Information, Non Financial Information and Financial information are 42.3%, 18.5%, and 21.1% respectively. As seen from the table, the overall disclosure score was the highest for strategic information as compared to the non-financial information and financial information.

### **5.5.1 Strategic Information**

The Strategic information scores are given in Table 5.2 Panel A. The results indicate that it is a better-disclosed area by the companies. The mean disclosure score for strategic information was 43.6%. The maximum score was 84.6%. Out of the total firms, 42 firms had a score below the median scores. 55% of the companies had a disclosure score between 25 to 50% of the total scores, indicating similar information disclosed. Many companies have provided some information on the corporate mission in the annual report.

#### Corporate General Information

In the strategic information group a relatively poor areas of disclosure is

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<sup>305</sup> The errors between the two were less than three percent. The final scores were arrived at after

the general information group. The organisational structure and the general information about the company are on an average disclosed by only 17% of the companies. Many companies have not given this information on the historical developments or major changes in the structure in the past, or the year of incorporation that would give the background information.

A good disclosure is given by BSES Ltd under the Corporate Profile giving a brief history, products and markets serviced etc.

The business structure giving the major operating division and the major product services are given in GTL Ltd. GTL has also given the major strategy and strengths of each business unit or division. The organisation chart presented by the company presents the different function heads along with the names in the Annual report.

Arvind Mills Ltd does not present organisation chart/structure. Colgate Palmolive (I) Ltd organisation structure/chart is not given.

Disclosures practices by companies are given in Appendix 9 Panel 5.1 along with disclosures of a few international companies as examples.

#### Statement of strategy and objectives

The Statement of strategy and objectives has been disclosed by 72.6% of the companies. This is a high disclosure area. A possible explanation for higher disclosures is that the Management discussion and analysis segment of the annual report includes several items that are part of the index. These items are 'Opportunities and Threats' and 'Outlook'. Strategic information about the company would generally be disclosed in this section. The information was also found in the inside cover, at the end of the annual report and in the Chairman's statements. Some companies gave specific information while for most of them it was very general statements. Information found in MDA, were about their marketing objectives and/or some future strategy. Other disclosures generally made by the companies included the economic prospects, risk related information cost reduction measures, and strategy adopted by the company to improve the performance. Very few companies had disclosed a general statement of social objectives. As discussed earlier, some companies have not given general objectives, as they may not have any specific statements to make

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the consensus was reached.

or formulated any strategy.

A statement of objectives is given by Tata steel in its Vision 2007 statement where the Strategic goals and strategies are discussed.

“Some of the strategic goals given are: Move from commodities to brands, like EVA positive core business, Continue to be the lowest cost producer of steel.”

Infosys Technologies Ltd give their social objectives under the Infosys foundation. They state that the foundation supports programs and organisations devoted to the cause of the destitute, rural poor, the mentally challenged, senior citizens and illiterates.

MTNL does not make any disclosure of its objectives or strategies. Disclosure practices of a few companies are given in Appendix 9 Panel 5.2

### Research and Development

The results of the disclosure index study shows that research and development is disclosed by 59.2 % of the companies in other than mandatory areas. Research and development is part of the mandatory disclosures in the Director's report and hence company would incur no extra cost in disclosing this information.

A few Indian pharmaceutical companies have given greater information on research and development activities unlike some other companies. For example, Dr. Reddy's Laboratories Ltd (pages 10-21), in their 'discover research section' discuss the molecular research initiatives taken and other research and product development activities along with stages of research in some of the projects.

Abbot India has not given any additional information on research and development. The MDA reports 'that the company will introduce new products and focus its investments in these core (diabetes care, urology, pain management etc.) areas coupled with stringent cost management efforts'. Many companies have made only a general statement such as "our R and D team continues to develop new products, renovate existing ones and is involved in improving production facilities, packaging systems and processes."<sup>306</sup> Disclosures by companies are given in Appendix 9, Panel 5.3

### Future Prospects

The future prospects or the forecasts statements are disclosed, on an average by only 13.5 % of the sample. The majority of the companies disclosing qualitative forecasts were only a general indication of whether the results will be better or worse compared to the previous year. Some companies have linked the current trends and uncertainties in the industry to their own performance and prospects in the near future. While companies made general statements, the quantitative forecast was a poor area of disclosure. A few companies did not provide any information about their future outlook. A reason could be that companies were cautious and did not want to discuss the future prospects or forecasts.

A few companies in the IT sector have disclosed quantitative information also. Infosys Technologies Ltd state that their net revenues are expected to be between \$636 million and \$654 million for the year ending 31<sup>st</sup> March 2003. The EPS per ADS is expected to be between \$1.43 and \$ 1.47 for the fiscal year ending 31.3.2003. Many companies have made only a general statement.

Cipla Ltd makes a general statement that the 'company is confident of maintaining a robust growth in the coming years'.

Aventis Pharma Ltd under Prospects for 2003, states, " your company will continue to focus on top line growth and increased profits." This is the only outlook statement in the annual report.

The software industry disclosure on risks is elaborate and the discussion includes variety of risks as against, say, manufacturing industry. Companies must be given some guidelines for giving risk related information, as it is poorly disclosed area. A company's foreign exchange exposure is quite substantial, yet they do not disclose information on the foreign currency risk or their risk management.

Financial risk discussion by Digital Global Soft on 'Foreign Exchange Fluctuation Risk' states "The Company earns revenues in various foreign currencies with earnings in US Dollars being the highest. Hence, the company is exposed to risk arising out of fluctuation in the foreign exchange rate.

Mitigants: The Company constantly tracks and monitors the foreign exchange markets and has an efficient exchange management in place to minimise risks

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<sup>306</sup> Britannia Industries Ltd Annual Report 2002 at 3

arising out of fluctuations in foreign exchange rates. The company also selectively enters into forward contracts to hedge foreign exchange risk. (page 32-36 of Annual Report)

A few corporate practices on future prospects are given in Appendix 9 Panel 5.4 Risk related disclosures by companies are given in Appendix 9 Panel 5.5

#### Strategic Investment and disposals

The strategic investment and disposal are disclosed by 44.8 % of the companies. While some companies discuss in detail, certain other companies do not discuss the strategic investments at all.

For example, in Abbot India, the report of the Director mention that the “company has sold its Jejuri undertaking as a going concern together with its assets and liabilities”. The reason for the sale is not apparent from the disclosure.

#### **5.5.2 Non-Financial Information**

Non-Financial information scores are summarised in Table 5.2 Panel B. The average score is 19.4% and is lower than the strategic information. As these are purely voluntary information the disclosure levels are quite low. The average raw score is only 5.23 although the maximum score is 73. Table 5.2, Panel B indicates that except for social responsibility statements, all others i.e. the value added statements, Director related information and the information related to employees are poorly disclosed areas.

#### Director Related Information

Director's information included in the disclosure checklist is mandatory when Directors are appointed or reappointed. These are voluntary for others. Companies have given information about the Directors who are appointed/ reappointed indicating that only information that is mandated is disclosed. Some companies have given partial information and have not given the age or in some cases other Directorships held. For example, ITC Ltd gives information about its Board of Directors. Ingersoll-Rand (I) Ltd does not present any voluntary disclosures regarding the Directors. GTL Ltd presents the Directors information

along with their age and prior experience. The photograph of the Directors is also presented.

#### Employee information

Only 14.7 % of the companies have given employee related information. Employee information related to categories of employees, line of distribution of the employees, equal policy statements are poorly disclosed areas. Companies are found to make very general statements and do not give any additional details. All companies in the public sector disclose information on the recruitment and position filled, based on reserved category of employees under different groups. (page 24, BHEL, Annual report,2002). Gas Authority of India Ltd has given break-up of physically handicapped persons as well as the percentage of women employed.

Training related information is given by 55% of the companies but they are general statements and very few companies have given specific details. Many companies do not disclose the number of employees trained or the amount spent on training. This information is voluntary and hence companies may not think necessary to disclose any additional information or the training itself may not be an important activity.

Gujarat Ambuja Cements Ltd states "further to enhance their skills and enrich their experience, the company provides continuous training. These include workshops, courses, overseas seminars and visits to cement plants in India and abroad. Off late, we have also started in-house conferences for various disciplines."

MICR Ltd give "training emerged as the strongest insurance against skill obsolescence. In 2001-02 the company invested 2801 man days of training". The report also gives details on the types of training given to the employees.

Safety policy and accident information are provided mainly by high risk companies Gas Authority of India Ltd, disclose, "that no fatal accident has occurred during the year" and the safety awards that it has received.

Reliance Industries Ltd makes 'Health Safety and Environment' related disclosures in their annual report.

#### Social Policy statements

The safety of products and the environment protection related disclosures are considered important areas in the western countries. The Kings Report on Corporate governance recognises this fact. 43% of the companies have made social policy statements. Community programs and charitable donations are well-disclosed areas. The safety of the products is disclosed only 34 % of the companies.

Under environmental information, the company's environmental policy and the impact of company's operations on the environment have rarely been discussed in the annual report.

Companies have disclosed only general statements instead of any specific initiatives in various areas. Novartis Ltd states that "health safety and environment aspects are key priority for the company and it takes appropriate measures to improve all business operations with regard to health, safety and environment." Raymond Ltd: No social policy statements are disclosed.

TATA Steel has given disclosures on the various social and community initiatives taken by it (pages 5 and 6)

#### Value Added Statements and Other Information

11.2% of the sample companies disclose value added information. Value added statements are disclosed by are Infosys, GTL Ltd, Hindustan Petroleum Corporation Ltd and Hindustan Lever Ltd amongst others. These companies have positive value addition.

Other information like litigation and government policy effect on sales are disclosed only by 21% of the companies.

Corporate disclosure practices on Non-financial information is given in Appendix 9, Panel 5.6

#### 5.5.3 Financial Information

Financial information disclosure scores are given in Panel C of the Table 5.2. The results indicate that this is another poorly disclosed area. The average disclosure score is 4.7 (24.7%) and the standard deviation is 13.6 %. The maximum score by a company is 68.4 %. The maximum score for all the three types of information come from the three companies, whose disclosure scores are highest in the sample, indicating that a company that has high levels of voluntary disclosures will disclose well in all the three categories of information.

## Competitor and Market Share Analysis

Quantitative information regarding the market share and competition are poor areas of disclosure by companies. Only 26% of the companies give the information on competitors and market share. Many companies do not even mention the existence of competitors. General statement on market share is given with no specific quantities mentioned by many.

- Raymond Ltd states, "The Company has registered an increased market share."(page 7) Colgate India Ltd, state " The economy toothpaste re-launched to cater the economy segment has now garnered a market share of over 4.5%"
- MIRC Electronic Ltd gives a detailed analysis for market share along with the figures for competitors.
- MTNL Ltd states; "The business condition during the year under review were quite challenging. Your company not only overcame the competition in cellular and WLL field but also came out with flying colours."(page 32)

## Financial Review

Companies have used different methods to discuss the financial performance. Descriptive information, ratio analysis, charts and graphs have been used. Some companies have not presented meaningful discussion on the performance and have just reproduced the figures from the profit and loss account. Discussion on liquidity and cash flow from operations are weak areas of reporting specially when the cash flows are negative. The three broad categories of information studied were the Ratio analysis, financial history data summary and others such as the dividend policy, disclosure of intangibles and effects of interest rate on the results etc. The results are discussed below.

### Ratio analysis

40% of the companies discuss a few of the ratios at one place or the other. The companies in the public sector give the financial review by the Comptroller and Auditor General of India, which contains the ratio analysis and review of key figures in the annual report. Since the review format is similar for

the government companies ratios generally are covered in these reports. A few companies have given all the ratios, while some have given selectively only those ratios that are favourable.

GTL Ltd has given a comprehensive ratio analysis for three years. (page 96)

Dabur India Ltd does not give ratio analysis.

#### Financial History summary

Within the financial information the financial history of four years or more is a widely disclosed area, most of the companies have given this information. The amount of information under this category varies from company to company. Bharat Petroleum gives summarised information in detail from 1976.

Dabur India Ltd has given 5 year financial history. (page 90).

#### Other Disclosures

Information on effects of inflation, dividend policy and intangibles are not commonly disclosed.

- Dr. Reddy's Laboratories Ltd: Brand Valuation is given, along with EVA computations in page 30 and 31 Market value added.
- Hindustan Petroleum Corporation Ltd has used the Lev and Schwartz model for valuing human resources. The value of human resources is given along with certain ratios. (page 47).
- Infosys Ltd has disclosed information on intangible assets score sheet, which is unique and not found in any other annual report. (Page 111-113) Human Resource Accounting, Brand Valuation and Current cost adjusted financial statements are provided.

Corporate disclosure practices on financial information is given in Appendix 9, Panel 5.7 and few other disclosures are given in Panel 5.8

To sum up, the analysis of disclosure index study reveals varying levels of disclosures among the companies and in many cases are inadequate. It is recommended that till markets mature disclosures will have to be mandated and enforced. Additional disclosures recommended are given in Section 5.10. A-varying level of disclosure indicates that there are certain factors affecting the

disclosures levels amongst the companies. In the next section we discuss the corporate attributes that affect the disclosures.

## **5.6 Attributes Affecting Voluntary Disclosure Practices**

The corporate disclosure literature suggests several attributes that influence the voluntary disclosures made by the companies. These factors are discussed below.

### **5.6.1 Size of the firm**

One of the important variables taken in many disclosure studies is the size. Usually large firms disclose more information as they may have low cost of generating the information<sup>307</sup> and companies may tend to allocate larger resources for production of these information.<sup>308</sup> These firms may have multi products and having operations covering larger areas. These companies will require and produce more information for their own internal decision-making and for evaluating the different divisions. Consequently, no additional cost may be involved for generating voluntary disclosures. Smaller firms may be at a competitive disadvantage against larger companies in the same industry and they may not freely disclose. Moreover, the cost of generating the information may be high for smaller firms. Larger firms also have greater agency cost and they would feel a need to disclose more information. Prior studies indicate that size of the firm, as measured by book value of the assets, total market value of the firm or total number of shareholders or sales has been positively associated with disclosure levels i.e. large firms follow better disclosure practices in developed countries.<sup>309</sup> In this research size is proxied by the market capitalisation and were logarithmically (base10) transformed as their distribution was positively skewed. Thus the following hypothesis is made:

**HYPOTHESIS 1: The association between the size of the company and the level**

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<sup>307</sup> G. Foster, Supra note 122 at 44

<sup>308</sup> G.J. Stigler, "The Economics of Information", 64(3) *Journal of Political Economy* 213-225 (1961)

<sup>309</sup> See studies by Meek et al, Supra note 108, See Cerf, Supra note 273 and also Singhvi and Desai, Supra note 274 where size is positively associated with higher disclosures.

of disclosures will be positive.

### **5.6.2 Ownership structures**

The pattern of ownership has great influence on the working of a company. Modern corporations are identified by separation of ownership from control. This gives rise to the agency cost resulting in conflicts of ownership and management. In such cases, because of wider ownership, shareholders will demand higher information from companies for monitoring them. An additional view is that the professional managers of such companies would like to assure the shareholders that they are acting in the interest of the shareholder and will give more disclosures. In countries where the substantial ownership of shares are concentrated in the hands of families or in banks like in Germany, higher insider ownership implies better incentives to monitor, greater incentive alignment and the disclosures of information are already with the shareholders. In such cases the disclosure of information is generally low. Prior studies have shown that concentrated ownership has negative relationship with disclosures. Earlier studies found a strong relation between the ownership pattern and disclosures of countries in Hong Kong, and Singapore.<sup>310</sup> Researchers also put forth a contrary view that may be valid for countries like India. When there is dispersed ownership, individual shareholders do not have greater influence on the companies and their disclosure policies.<sup>311</sup> In such cases the theory that wider ownership and better disclosures may not be presumed.

Under the listing agreements, all listed companies must give the details of the distribution of the shareholding, but no format has been prescribed. The names and holdings of the top 50 shareholders of the company have to be filed with the Stock Exchange. Companies have disclosed information in a variety of ways as the format for disclosures have not been mandated. Most companies have provided the shareholding in terms of number of shares held and the number of shareholders. Many companies have also given the disclosure of categories of shareholders classifying them into Promoters, Financial institutions,

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<sup>310</sup> See Chen and Jaggi, *Supra* note 120 at 385-310, for a discussion on ownership structures and disclosures.

<sup>311</sup> R.J. Zeckhauser and J. Pound, "Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance in Asymmetric Information", *Corporate Finance and Investment* (R. G. Hubbard ed., Chicago: the University of Chicago Press, 1990)

Non resident holders, Foreign institutional investors and the general public. The promoters and group holdings relates to both direct and indirect holdings of shares. However, it is not clear if the companies have cross holdings from associate companies or through private companies in which case the company's ownership disclosure is not very transparent and hence to a certain extent may affect the result. The ownership structure for this research is defined as the proportion of voting shares of the company owned by the corporate insiders or promoters directly or indirectly. In a few cases, where the insider holding of shares is not given in the annual report, the shareholding percentage was then taken from CMIE Prowess.<sup>312</sup>

HYPOTHESIS 2: The association between higher ownership and the level of disclosures will be negative.

### **5.6.3 Government ownership**

A major feature of the Indian economy was the dominance of government companies also called the public sector companies till recently. The government holdings range from 26% to 93.56% in the sample companies as the government has now disinvested in many of the companies. A feature of such companies is that the Comptroller and Auditor General of India is consulted for appointment of auditors for such companies. In an earlier research by the ICAI, it was found that public sector companies made better disclosures than private companies. The Government ownership is taken as a dummy variable in this research. It is perceived that government companies have less incentive to disclose information and hence the hypothesis is as follows:

Hypothesis 3: The association between the Government companies and the level of disclosure will be weak.

### **5.6.4 Multinational ownership**

Multinational companies have their parent companies in other country and have operations in more than one country. Companies with promoters as multinational companies bring with them rich experience and practices of other

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<sup>312</sup> CMIE, Centre for Monitoring Indian Economy, Prowess Data Base

developed companies. Companies having multinational affiliations are influenced by the parent company to a great extent. The variety of information demanded by the parent companies with their better reporting systems can result in the increase in voluntary disclosures. This may be possible, as they may not incur any additional costs on disclosures.<sup>313</sup> International agencies like United Nations, OECD and others frequently monitor and evaluate the multinational corporations because of their importance in the global trade. Multinational companies have been frequently accused of tax evasion and other practices like transfer pricing which may end up paying high political costs. These multinational companies will therefore fully comply with the mandatory disclosures and also give greater voluntary disclosures in order to avert any pressure for excessive control or for expropriation. Multinational affiliation of a company is significant variable explaining disclosure levels in countries.<sup>314</sup> The sample company is considered to be multinational affiliated or owned when the holding company has operations in more than one country. The variable is coded as 1 for multinational affiliation and 0 for others.

Hypothesis 4: Multinational companies will show a positive association in relation to the level of disclosures.

### **5.6.5 Foreign investors**

The foreign investors include the institutional investors as well as the American and Global Depository holders. The figures of the foreign holdings are taken from CMIE Prowess Data Base. The foreign institutional investors were allowed to invest in Indian companies after the liberalisation. Foreign investors will normally invest in companies that have less group affiliates i.e. concentrated ownership because of problems in monitoring. Nevertheless, when they invest in group companies, they will invest in groups which are more transparent. Hence, the Foreign Institutional Investor will serve as a valuable monitoring institution in the emerging markets. Foreign Investors will also serve as a validation to the

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<sup>313</sup> F.D.S Choi and G.G. Mueller, *International Accounting*, Chapter 7 (New Jersey: Prentice Hall, 1992)

<sup>314</sup> Ahmed and Nicholls See Surpa Note 119 at 62-77

disclosures by companies.<sup>315</sup> Companies, which are listed in the international stock exchanges, face additional pressures for disclosures than companies, which are listed only domestically. These companies do not incur more additional cost in gathering the information and hence have incentive to disclose more. In the study by Cooke, the Swedish and Japanese firms disclosures were affected by international listing status. Gray et al found similar findings in their sample for the US, UK and Continental European multinational companies.<sup>316</sup>

Hypothesis 5: Companies that have high foreign holdings will give greater disclosures.

### 5.6.6 Industry

The disclosure standards may vary according to industry, as each industry has its own competitive disadvantage in disclosing certain proprietary information. The pharmaceutical companies may not give more information on their research activities as this may directly affect their competitive status in the business. Some items of disclosures may be more relevant to some industry than others. Certain industries in high technology (Information Technology and Media) may disclose more information for better valuation purposes and also due to heavy competition than other traditional industries. The disclosures may also depend on the product line or the diversity of the products of the company. Multi-product companies may have more information than single product companies. The industry type may thus have some influence on the disclosures of the companies. Cooke finds some evidence of an industry effect in companies from Japan and Sweden.<sup>317</sup>

The sample companies in this research are classified into three groups. The first is the service industry in the high technology area consisting of software and other telecom service providers. The second group is the pharmaceutical and chemical companies. The rest is taken under others. The industry variable is coded as Industry Hi tech =1, 0 for others. Industry Pharmaceuticals and

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<sup>315</sup> T. Khanna and K. Palepu, "Emerging Market Business Groups, Foreign Investors and Corporate Governance, NBER Working Paper Series No. 6988, <http://www.nber.org/papers/W6995> (Oct 10, 2001)

<sup>316</sup> Meek et al Supra note 108 at 555-572

<sup>317</sup> T.E. Cooke, "An Assessment of Voluntary Disclosure in the Annual Reports of Japanese Corporations", 26(3), *International Journal of Accounting* 174-189 (1991)

chemicals are taken as 1 and others as 0.

Hypothesis 6: The high technology oriented service industry will have a positive association with respect to the level of disclosures. The chemical and pharmaceutical will have a negative association with the disclosure.

### **5.6.7 Size of the auditing firm**

The external auditor is an important element in the system of corporate governance. He/she lends credibility to the financial statements prepared by management, so that users of the statements can rely on their fairness and completeness.<sup>318</sup> The existence and process of mandatory annual audits can have salutary effects on management actions and accountability. The agency cost theory would suggest that managers rent the reputation of a high quality auditor in order to lend credibility to their disclosures and avoid costs of nondisclosure. Given these benefits firms have incentives to increase disclosure and employ high quality auditors as complements to increase the value of the firm. Auditors play a major role in the disclosure policies and practices of the clients. Studies have found that audit quality is influenced by the size of external auditing firm.<sup>319</sup> De Angelo, states that the value of an external audit depends on how the users view the auditors report in the annual report. This perception is formed on the basis of the audits ability to discover and report material fraud and misstatements. Similarly, they may bring their expertise from other audits to suggest improvements in the disclosures of the firms. Prior studies show a positive relation between the disclosures and external audit.<sup>320</sup> In this research, the big auditors are classified into big four auditors having international affiliation and big four Indian auditors. The big Indian auditors are selected on the basis of concentration ratio or the extent to which the auditors dominate the market for audit. The Indian big four auditors are selected on the basis of number of companies they audit. For this the BSE 500 companies are selected and the big

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<sup>318</sup> The credibility of financial statements will also depend on the quality (or credibility) of the prevailing accounting standards.

<sup>319</sup> G.J.Benston, "The Establishment and Enforcement of Accounting Standards: Methods, Benefits and Costs" 11(41) *Accounting And Business Research* 51-60 (1980) and L.E. DeAngelo, "Auditor Independence, 'Low Balling', and the Disclosure Regulation", 3 (2) *Journal of Accounting and Economics* 113-127 (1981)

auditors are selected on the basis of number of companies they audited in this group. The sample companies audited by big foreign firms and big Indian firms are represented by dummy variables.

Hypothesis 7: Big Auditors will have a positive association with the level of the disclosures.

To sum up, prior studies in the area of voluntary disclosures thus looked into firm specific determinants and their effect on disclosures. Other variables like, source of external financing, and profitability been found to have important influence on the country disclosures. International published studies focus only on the developed countries like the USA and the UK and very few studies include India. In the last few years there has been a change in the economic environment of the country. Many companies are accessing the global market for their finance and revenue. A few Indian companies have also listed in the foreign stock exchanges. Pharmaceutical and software have become global companies. These variables are expected to capture the developments, which may influence the disclosure practices of the companies.

The variables or factors influencing the disclosures are selected if they have some theoretical consideration or on a priori assumption. These variables are easily measurable and for the purpose of analysis, and are easy to classify the sample companies as required. The independent variables studied in this research are the 1) Size, as proxied by market capitalisation. The market capitalisation is taken to the log base 10 2) Ownership Structure is classified as percentage of holdings 3) Ownership Distribution is classified into two groups: a) Ownership holdings by Multinational companies 4) Ownership by Government Companies and others. These are taken as dummy variable 0,1 5) Percentage of Foreign Institutional investors holdings to the total holdings 6) Sample companies are classified into three groups a) As Hi-technology Service Industry consisting of (Information Technology and Media companies and other service providers) b) Pharmaceuticals and Chemical companies c) Others (taken as dummy variable 1,0) 7) Auditor size based on big four auditors and big Indian auditors and others again taken as dummy variables 1,0.

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<sup>320</sup> Studies showing positive relation include those by A R Cerf Supra Note 273 and S.S Singhvi and H B Desai. Supra Note 274 at 129-138

## 5.7 Descriptive Statistics and Independent Variables

Descriptive statistics of the sample are given in Table 5.3. The sample consists of 86 big companies listed as part of the Bombay stock Exchange (BSE 100). The market capitalisation of the sample companies is about Rs. 3890 billion. The average market capitalisation of the sample companies was Rs.4526 Crores indicating that the firms in the sample are considered big in terms of size. The statistics on profit margin indicates that a small number of firms (3 %) have negative profit margins.

The average ownership holding by substantial shareholder for sample companies was 49% and the median is 49%. Out of the sample, 8% of the companies where holding is less than 25% which is the threshold limit for passing special resolutions. The majority of the shareholding (79% percent of the companies) varies between 25 and 50% holdings. Only promoters of 12 % of companies hold shares above 75 % of the total share capital. The Government ownership concentration is about 72% and multinational companies have an average holding of 55% (Median 58.7%) in the Indian affiliate companies indicating a substantial holding in the sample companies. The maximum holding is 74%. In the others, the average shareholding by the majority shareholder or the promoter holder is 40 % with a median of 36.7% indicating that promoters and dominant shareholders of companies have greater control on the overall working of the company even with a moderate level of ownership.

In the industry wise distribution Chemical and Pharmaceutical companies have average promoter/substantial holding of more than 51% indicating higher ownership concentration. The ownership concentration is 43.7% (Median 41.77%) in the service industry.

The foreign institutional holding including foreign listed shares on ADR and GDR is about 9%, (Mean) with higher investment in the service sector. The big auditors are found in about 52% of the companies. Multinational companies in the sample generally appoint big auditors. Big auditors are rarely found in the Government companies due to poor remuneration or because of audit rotation.

## **5.8 Results of the Study on Factors Influencing Levels of Voluntary Disclosures**

In order to study the relation between the disclosures and the factors affecting the disclosures Pearson correlation analysis was performed. The Pearson correlations between the variables are presented in Table 5.4. The results suggests a significant and positive association between the total disclosures score and the size of the firm proxied by market capitalisation indicating that big companies disclose more information. This confirms the results of the earlier studies to Indian sample also. The results also indicate there is negative correlation between the ownership pattern and the total disclosure scores indicating that substantial ownership holding are associated with poor disclosures in general. In terms of the three types of information, strategic and financial information are associated negatively with higher ownership holdings. The results also indicate that the financial information disclosure is negatively related to multinational company affiliation ( $p < .01$ , two tailed). Foreign Investors also show a strong association between the total disclosures and the strategic and financial information. The service industry consisting mainly of software companies' show a strong association to the total disclosure scores and the strategic information disclosed. Weak relation is found between the non-financial disclosures and the government companies (at  $p < .1$ ). Other variable in the study namely the big auditors both Indian and foreign show no correlation to the disclosures made by the companies. Big auditors are associated with Pharmaceutical and Chemical industry where the total disclosures are not high (significant at only .07). The only inference that can be drawn, is since the companies are audited by big firms, companies may choose to disclose only on need to know basis and in a way big auditors gives a positive assurance to the stakeholders. The results of the regression analysis follow.

### **Regression results**

Next, a regression analysis was used to investigate the association of variables to the voluntary disclosures index (DISCIN). The results show that some independent variables are closely related to each other and

complementary to each other. Therefore, a separate regression analysis is performed for each of the independent variable along with the market capitalisation to control for the size of the company. OLS regression was performed on the sample and the results are presented in Table 5.5 Panel A, Panel B, Panel C and Panel D for the different types of disclosures.

In all the disclosures types, the size of the firm is statistically significant and high showing that big firms generally give more information. The findings are consistent with the results of previous research looking into disclosures. The hypothesis that larger firms give more comprehensive information is confirmed.

Regression 1 is estimated with the ownership pattern and the total disclosures scores controlling for the size proxied by market capitalisation. The F value is 11.351 of the model and is significant at .001 levels. The adjusted  $R^2$  is 19.6%. The OLS regression coefficient is negative and significant suggesting that higher ownership holdings are associated with overall lower voluntary disclosures. Similar results are obtained for the strategic and financial disclosures given in Panel B and Panel D. The non-financial disclosures are not significantly associated with the ownership structures indicating that firms have made similar low disclosures. These results suggest that the ownership structure is negatively associated with the level of disclosures. The results have policy implications in favour of mandatory disclosures.

Regression 2 suggests that the multinational affiliation has no significant association with the overall and strategic information disclosures. The results are significant only for the financial information ( $p < .01$ ) and a weak association for the non-financial information. The coefficient is however negative. Two reasons can be attributed to the poor disclosures. Multinational firms are found in the Pharmaceutical and Chemical industry (48% of the sample multinational firms are in pharmaceutical and chemical industry, where the disclosures may not be adequate due to competition and the proprietary nature of information. The multinational shareholding in the Indian companies are also high with the median ownership holding of about 58 %, indicating that multinational firms will generally disclose only on the need to know basis and what is mandatory provided by law.

The results of the Regression 3 suggest that there is no association between the overall disclosures and the government ownership. This indicates

that government companies are generally not high in voluntary disclosures and continue to disclose only what is mandated. They generally do not disclose much on the strategic information which is significant at  $p < .05$  level. The results are inconsistent with the earlier Indian study which reported higher level of disclosure by government companies. It may also mean the over period private companies have started disclosing more information than the Government companies.

Foreign investors (FI) association with disclosures are given in Regression 4. The results suggest that there is positive association between the foreign institutional investors and the overall disclosures scores ( $p < .02$ ). Only the non-financial information is not significantly associated with the FI ownership. The positive impact of foreign financial institutions on disclosures is due to the better valuation of the companies stocks when the FI's invest. These results are consistent with the earlier studies, that envisage the increase in governance codes and structure and when companies go for global funds where they have to convince the global investors.<sup>321</sup> Khanna and Palepu (using data relating to 1990-94) concluded that foreign institutional investors are good monitors.<sup>322</sup> Our findings also support the result that group affiliation and in this research the higher ownership concentration reduces the possibility of foreign investments. Thus, indicating that foreign institutional investors serve as a valuable monitoring tool. There is an indication that the foreign investor holdings are associated with better disclosures.

The impact of industry on the disclosures is given in the Regression 5 and Regression 6. The results indicate that service industry comprising mainly of the Software and Telecommunication services company have a positive association ( $p < .05$ ) with the overall disclosures scores, indicating that the high disclosures are made by companies in the service sector. The disclosures are however significant only for strategic information ( $p < .01$ ). Non-financial and the financial information show no significant association. The results confirm that companies

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<sup>321</sup> R M Stulz, "Globalisation of Equity Markets and the Cost of Capital", Paper presented SBF/NYSE Conference on Global Equity Markets. (1999) Dice Center Working Paper no. 99-1. <http://ssrn.com/abstract=153669> (Mar 06, 2000)

<sup>322</sup> T. Khanna and K. Palepu, "Emerging Market Business Groups, Foreign Investors, and Corporate Governance" [www.nber.org/working paper no 6955](http://www.nber.org/working paper no 6955) (Mar 12, 2003)

wanting better valuation will disclose more information.<sup>323</sup> In the service sector especially as the assets are mainly intangibles and the market for their services are international. In terms of the Pharmaceutical and Chemical companies there is no indication of significant association between the variables.

Regression 7 indicates that big auditors have no significant influence on the voluntary disclosures made by the companies. The results are not significant for both the big Indian as well as Big foreign affiliated auditors. The earlier studies found conflicting results with respect to auditors.<sup>324</sup> As noted in some of the earlier studies, the size of the audit firm was not significant in the level of disclosures.

The above result showing a significant negative relationship between the ownership structures and voluntary disclosures have implications for the policy makers. Unless there is specific mandate there will not be much initiative by companies to disclose information. One can infer that regulators have to regulate more disclosers or they can encourage better governance practices, which will make the companies, disclose more.

In order to provide the user perspective to the annual report, a primary survey of individual investors was performed. The results of the study are discussed in the next section.

## **5.9 Investor Perception of the Annual Report**

The corporate annual report is seen as an important device for communication between the management and shareholders. In the last few years there has been a considerable change in the requirements of the mandatory disclosures. Various Committees recommendations have been implemented thereby increasing the information provided to the shareholders. These additional information involves costs but this cost may be justified if the investors understanding of the annual report has improved. Studies find that that the corporate communication is weak and not well understood by many

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<sup>323</sup> D.S.Gelb and P.Zarowin, "Corporate Disclosure Policy And The Informativeness of Stock Process", 7(1) *Review of Accounting Studies* 33 (2002)

<sup>324</sup> See C.L. Marston and P.J. Shrides, "A review of the development and use of explanatory models in financial disclosure studies" *Conference paper*, 19 th European Accounting Association Annual Congress, Bergen, 11 (1995) for a summary of the findings.

shareholders and found many deficiencies in the annual report.<sup>325</sup> These studies found that Shareholders have become self reliant on decision making and found that the annual report was most useful source of information for decision making.

The objective of this research is therefore to explore the current practice, perceived effectiveness of and ways to improve the corporate disclosure by listed companies for the benefit of the small investors.

### 5.9.1 Methodology

Prior studies have used the questionnaire method to study the extent of the shareholders reading of the annual report. Survey is a most common method used to determine the views of the respondents on subjects.<sup>326</sup> The construction and validation of the questionnaire for this research was based on an extensive review of the literature and previous similar questionnaire surveys conducted in other countries. Surveys studies by Ho and Wong, Abu-Nassar and Rutherford , Eccles and Mavrinac were examined for developing the questions.<sup>327</sup> Some other items were derived from discussions with professional accountants and academicians. Two academicians reviewed the draft questionnaires.

The questionnaire contained fourteen questions including one on the respondent's profile. The questions related to the source of information for decision-making and their relative importance in decision-making. The perceived importance of certain information in the annual report and the extent to which different types of information in annual reports are read/used by the respondents was also part of the questionnaire. Reasons for not using the annual report or some parts of the annual report were also part of the questionnaire. Space was

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<sup>325</sup> For example see the studies by: R.D. Hines, "The Usefulness of Annual Reports: The Anomaly between the Efficient Markets Hypothesis and Shareholder Surveys", 12(48) *Accounting and Business Research*, 296-309 (1982); M.J. Epstein and M.L. Pava, "How Useful is the Statement of Cash Flows", 74(1) *Management Accounting* 52-55 (1993); S. A. Bartlett and R. A. Chandler, "The Corporate Report And The Private Shareholder Lee and Tweedie Twenty Years On", 29(3) *British Accounting Review* 246-261 (1997)

<sup>326</sup> D.H. McBurney, *Research Methods* (Singapore: Thomson Wadsworth, 2001)

<sup>327</sup> S.S.M. Ho and K. S. Wong, "A Study of Corporate Disclosure Practice and Effectiveness in Hong Kong", 12(1) *Journal of International Financial Management and Accounting* 75-102 (2001) also, M. Abu-Nassar and B. A Rutherford, " External users of Financial Report in Less Developed Countries: The Case of Jordan", 28(1) *British Accounting Review* 73 -87(1996); R. G. Eccles and S.C. Mavrinac, "Improving the Corporate Disclosure Process", 36(4) *Sloan Management Review* 11- 24 (1995)

provided for the respondents' comments and suggestions on the related issues. The covering letter requested the investors to complete the questionnaire.

To achieve the objective of the study, questionnaires were sent to 785 individual investors. These were administered through post and through brokers were randomly selected. Sixty-four responses were received within three weeks of mailing/distribution. Another follow-up letter was sent to investors/brokers who did not respond at the first time. The remaining questionnaires were returned after 4 weeks. The survey resulted in 172 (response rate of 21.91%) usable responses.

In order to establish the reliability and validity of the data obtained, the responses to four randomly selected questions from the last 20 questionnaires received were compared with the results of the first 20 questionnaires in order to check for any possible non-response bias. The use of split-half technique indicated no significant difference between those who responded early and those responding later. This implies that those who failed to respond may not necessarily have different perceptions from the respondents who did respond.

### **5.9.2 Results of the study**

The results of the study are given in Appendix 10 Panel A, B, C and D. These are discussed below.

#### **1. Use of different sources of information for decision-making**

Investors use information provided through different sources for decision-making. These include the Annual report, Quarterly reports, Press releases, Stockbrokers, Television Media, Analysts reports and Computer databases. The results indicate that the respondents view the company's Annual Reports and the Quarterly reports as the most referred source of information for decision-making with a mean of 2.56 and 2.42 respectively. Followed by analyst's reports and newspaper articles. The advice of stockbroker, friends and colleagues were considered least for decision-making and were also ranked the lowest.

The relative rankings also indicate that while investing, the quarterly information is most important followed by the annual report. Given the timeliness of the quarterly report the results were rational. When it came to decision-making, information released or discussed in the TV media also turned out to be

important. Computer databases were not ranked high, as the technology is yet to take off in this country. Some of these results are consistent with the earlier finding of the prior studies of Hong Kong but not that of US.

## **2. Information in the annual report**

This section examined the readership of the different parts of the annual report and also to review the relative importance of those sections. The results are given in Panel B. The survey showed that 5 % of the respondents never read the annual report while 54.5 % sometimes briefly read the annual report. Investors were asked to indicate their relative usage of different sections of the annual report. The reasons for not using the annual report or certain sections of the annual report were also questioned.

The result indicated that the profit and loss statement was the most read statement followed by the balance sheet with a mean of 2.6 and 2.58. The narrative sections of the report seem to attract wider readership, especially, the earnings per share, MDA and the Directors report. The finding suggests that shareholders are also interested in getting an overview of the company and its performance along with pure financial data. The result also indicated that many do not read the recent additional information given in the annual report. The sections relating to consolidated financial statements seem to have had little impact on shareholders, with 25.45% reading thoroughly and even fewer 14.5% thoroughly reading the related party disclosure. A possible explanation could be that information is very general or in aggregate form to suit the investors needs. It may also mean that investors may take some more time to understand and use these sections of the annual report. Of the remaining sections of the company's annual report, only half the respondents read the shareholder information also referred as the 'Corporate Governance' section some time. This section of the report contained extensive information regarding share price history, current dividends and details of listings on overseas stock exchanges, in addition to details of the annual general meeting. The auditors report was ranked 8 with a mean score of 2.13 indicating a less usefulness of this information. This could be due to the lengthy nature of the audit report.

The findings, therefore, suggest that some parts of the annual report are largely ignored by shareholders, or at best, read only briefly. The relatively low usage of the annual report may be a reflection of the passive nature of many retail investors and their lack of interest in much of the detailed disclosure. This could also mean that all information needed by the investors is not available in the annual report in the form they need.

Studies in US indicate that the use of the annual report was declining due to lack of relevant information. The amount of information provided was bare minimum, mandated by regulators. Also, the financial information is based on historical data and do not provide insights on future outlook.<sup>328</sup>

Respondents were also asked to identify the reason for non-usage or relatively less use of information in the annual report. About 38.3 % of the investors found that the annual report was too long and 43.7 % felt some parts were difficult to understand indicating that the retail investors needed different type of information. 41.3 % felt that the report was inadequate and certain additional information was required. A high number of respondents (54.4 %) felt that the reports came too late to be useful for decision-making. The reporting process needs to be speeded up although the quarterly report comes much earlier a comprehensive annual report will also be useful if given in a timely manner.

Based on the sample responses it was perceived that the investor may need different information, and hence open-ended question was asked to ascertain the additional information to be included in the annual report. These responses could not be generalised although many wanted a short executive summary and a specific future outlook statement (rather than a general statement), which would be more useful. In order to be more specific, the questionnaire required the respondents to rank certain additional information like the Economic Value Added and the future outlook statements. The results are given in Panel D. The respondents ranked future outlook statement (opportunities and threats) as the most important, followed by Five-year financial summary of key figures, Economic Value added statement and key ratios.

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<sup>328</sup> M. Gibbins, A. Richardson and J. Waterhouse, "The Management of Corporate Financial Disclosure: Opportunism, Ritualism, Policies and Processes", 28(1) *Journal of Accounting Research* 121-143 (1990)

Three-year financial statement and top shareholders names were considered least important as additional information. Nearly 48% of the respondents preferred summary reports with key disclosures.

The overall conclusion drawn from this survey is that retail investors prefer less raw information but more relevant ones for the decision-making.<sup>329</sup> A summarised statement giving the key figures for five years along with select ratios would be relevant. Descriptive statements must be specific rather than a general discussion one. The future outlook and opportunities, competition and threats, specific risks and their mitigants would add more value to the financial statement numbers. A simple format for reporting is developed based on the study and is given in Appendix 11.

## **5.10 Suggestions for Improvement**

As observed in the study of voluntary disclosures, the disclosures made by the companies are very general statements and are not specific disclosures. It is also observed that this is a result of lack of specific information in the norms of SEBI, hence, managements have disclosed as little as possible. Coupled with high ownership, companies have disclosed information only on a need to know basis. It is recommended that additional disclosures be mandated till the markets mature and penalise companies for non-disclosure of relevant information.

The most obvious limitation of the disclosures, results from industry differences. Since types of transactions, and their frequencies, are likely to differ across an industry, it is tough for the regulator to define the disclosures in MDA or Directors report. The companies take advantage of this and conveniently omit certain issues of importance. On the other hand, some companies are over loading the annual report with duplication of information by discussing and repeating the same information given in the schedules and the financial statements without adding additional information. It is recommended that ICAI and SEBI formulate specific disclosure requirements in the MDA in the lines of

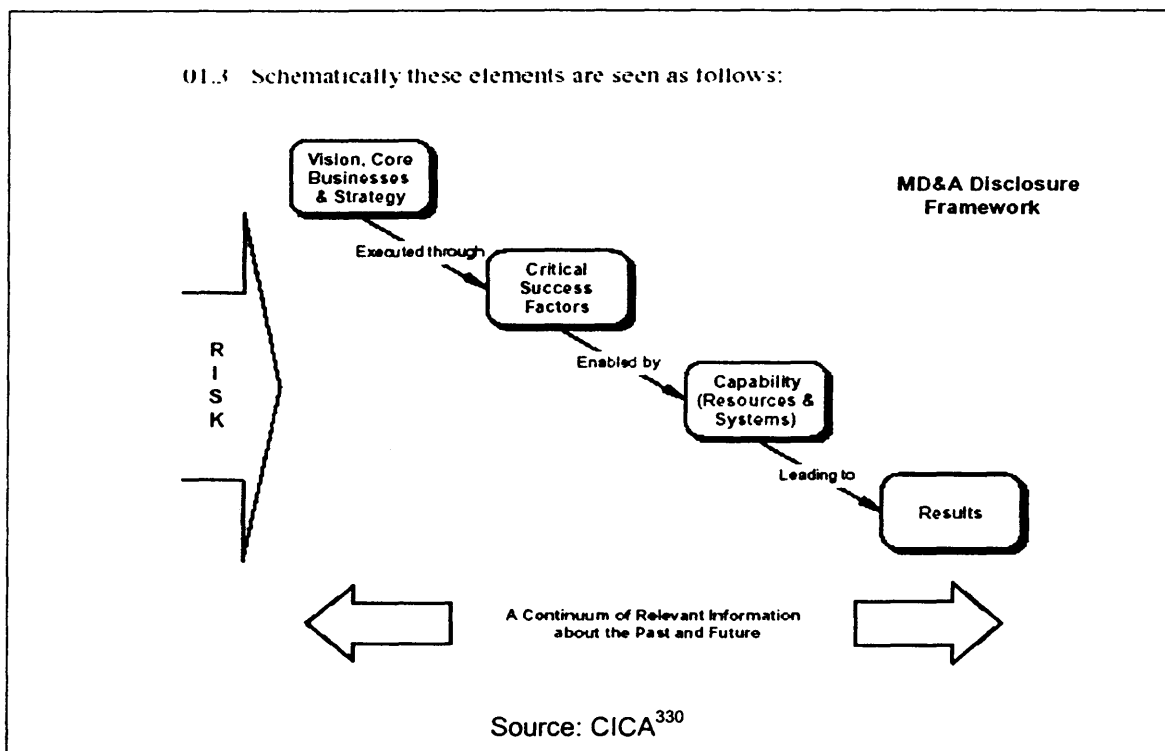
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<sup>329</sup> This would imply that either the primary statements are complex for the majority of retail investors or only a small amount of financial data is relevant to them. Investors' preference for the narrative sections of the annual report would in a way imply that the financial numbers are difficult for the investor to comprehend.

SEC in the US and other countries. A best practices guide can also be developed by these organisations.

As annual report is a general document received by all the shareholders, it is recommended that certain information be given in the annual report as it will then become a comprehensive document for all the stakeholders. As depicted in Figure 5.1, voluntary information should supplement the financial information and also be useful to the stakeholders. They should have a forward-looking orientation and focus on both long and short-term perspectives. Present as well as future are material to the decision-making needs of users.

**Figure 5.1 Framework for Disclosures in MDA**



Any voluntary information must possess the fundamental qualities of reliability, comparability, consistency, relevance and understandability.

The broad framework for reporting must include company's strategy and the critical success factors. Identification of performance measures and capabilities to achieve them. Discussion of results linking it the objectives would result in more informative MDA.

<sup>330</sup> Adapted from Canadian Management's Discussion And Analysis: Guidance on Preparation and Disclosure A Publication of the Canadian Performance Reporting Initiative Board Review Draft, Canadian Institute of Chartered Accountants [www.cica.org](http://www.cica.org), (Dec 2, 02)

## **Strategic Information**

The Companies Act requires the General business profile of the company, which is usually disclosed as the last item of the individual annual report. This must be expanded to include a brief history of the company and must be included at the beginning of the annual report. Since the brief history or the corporate profile gives all the relevant information about the company this information, covering the industry in which the company operates, the year of incorporation the nature of business and the principle products or services and their uses must be mandated to be disclosed. General information about the company and the organisation structure should be mandated

Strategic information disclosure includes items like the corporate objectives and mission statements. These are normally qualitative in nature and incorporate business and strategic ambitions. However, company aspirations are not always linked to targets that may be measured and assessed by investors. To be useful and credible, objectives should be specific to the industry concerned. They should also be measurable and realistic and may be set for a range of areas, for example: Unit sales, Market share, Productivity or, Unit operating cost reduction.

Future prospect or outlook information has been considered important by investors. Regulatory authorities like the SEC have also noted the need for such information. In view of this specific disclosure is recommended as part of the outlook statement in the MDA an indication of the expected operating results and the events that may affect the results for the coming year must be mandated. Further, more forward looking perspectives including future plans and measurement of uncertainties and risks should also be mandated.

## **Non-financial Information disclosure**

Companies are weak in disclosure of Non-financial items (average 19.5%). In the researchers view, this is partly attributed to the merit-based philosophy to regulation that is practiced for many years. These disclosures can be improved only through regulation if they have to be included in the annual report. Information about the Directors, the safety policy and the safety of the products statements should be mandatory. Environmental issues have become very important in the recent years and hence information on the effect of

company's products or the processes etc on the environment should be formulated and mandated.

### **Financial Information**

A review of operating results describes the significant features of operating performance for the financial period. It should discuss the performance of the main business segments and their impact on the group results overall, with comment on both successes and failures. Investors seeking to understand future results are particularly interested in the trends from year to year.

The review of financial information ideally must include: The impact of acquisitions and disposals on the current and future results, changes in the business environment including any governmental, economic, and other factors that materially affect the operations. Significant components of revenues or expenses affecting the operating results should be explained. Specifically, results of operations can be analysed with respect to changes in prices, new products, services and markets and marketing strategies. Some companies merely give the numerical changes from year to year, which are readily computable from the financial statements. Instead of merely mandating the structure, regulators can prescribe some additional guidelines for disclosures.

Naresh Chandra Committee recommended that management should provide clear description of risk factors and material liability that should be followed by the comments of the auditors.<sup>331</sup> This recommendation needs to be mandated

Discussion of resources and the cash flow statement is very valuable information for analysts. However, not many Indian firms discuss the cash situation. The existence of excess cash and bank balances nor the deficit from operations is explained. Hence, these are required to be mandated

The legal environment in countries like US discourages companies from disclosing forward-looking information because of litigation. At the same time companies are constantly threatened by the short-term repercussions on the stock prices. Good corporate governance calls for an un-biased but balanced reporting of the forward-looking financial information.

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<sup>331</sup> In Germany the Management report by the company requires to be audited.

Accounting standards does not allow the recognition of intangible assets in many cases even though the intangible assets are critical to the success of some business. Disclosure of information about unrecognized intangible assets such as human resource, innovations, research and development would be useful to investors in making investment decisions and hence must be mandated.

Managements have great discretion in disclosing information even when mandated. It is recommended that the following be mandated in the annual report in the MDA/ Directors report to add more meaning to the financial statements.

- Capital and other investments in the current period that will have an impact on the future results.
- Off balance sheet financing that the company has availed.
- Implications of the changes in the financial policies
- Reply to the auditors qualifications
- Discussion on performance to include liquidity and the negative cash flow from operations.
- Discussion on changes in accounting period
- The company's vision, core businesses and long-term business strategy, critical success factors; capability to deliver results; results and risks and its management.
- Environmental disclosures gains greater significance in the industrial world with the deterioration of our environment. Environmental disclosures in the form of environmental policy, the impact of company operations and products on the environment, issues that are relevant to the company must be mandated.

The review of financial information ideally may include:

- The impact of acquisitions and disposals on the current and future results
- Changes in the business environment, including any governmental, economic, and other factors that materially affect the operations.
- Significant components of revenues or expenses that should be described in order to appreciate operating results. Specifically these results of revenue and sales can be analysed with respect to changes in prices or

new products, services and markets that affected such results along with the market strategies.

- Actual performance against targets and significant features of overall operating performance and performance of important segments should be given successes and failures are to be explained in a balanced way.
- The main risk factors and influences that may affect future results, whether or not significant in the period of review

## **5.11 Chapter summary**

This chapter explored the corporate voluntary disclosure environment. The management gives the voluntary disclosures i.e. more than mandated by law. Voluntary disclosures were captured in the form of a disclosure index in this study. The disclosure index provides a reasonable method for measuring the overall disclosure quality of the firm. The disclosures were broadly categorised into Strategic Information, Non financial information and Financial information. The study of disclosure indices indicated that companies were relatively low in disclosure of voluntary information and differences in levels of disclosures were observed.

To examine the differences in the voluntary disclosures level, several factors were examined. These were the size of the firm, ownership structures, (multinational ownership, government ownership and foreign institutional ownership), industry and the size of the audit firm. A regression analysis was performed to test the explanatory power of these variables. To sum up the findings, the regression models were highly significant and had some explanatory power similar to those reported in the earlier studies. The voluntary disclosure analysis indicates that high level of disclosures is influenced by the size of the firm, concentrated ownership and the foreign investors investing in the companies. To a certain extent, they show positive association with high technology service industry. The overall disclosure scores were found significantly and negatively related to higher ownership holdings. The disclosure index was positively associated with foreign investors holding and the service industry mainly comprising of the high technology firms. The strategic disclosures were negatively associated with the ownership pattern and government companies. They were also significantly and positively associated

with foreign investor holdings and the service industry. The non-financial disclosures showed only a weak negative association to multinational companies. No other variables showed any significant association. The financial information showed significant negative association to ownership pattern and also to multinational companies. In all the disclosures, size was positively associated with the disclosure scores and no association were seen with the auditor's firm size.

A questionnaire survey was conducted to understand the investor's perception and needs from the annual report. The results of the survey indicate that company's annual report and the quarterly information was most referred source of information for decision making. In the annual report the profit and loss statement and the balance sheet was the most read, followed by the narrative sections like the MDA. Many did not read recent additions in the annual report like the consolidated financial statements. Respondents felt that the annual report was not timely. 44% of the respondents felt that some parts were difficult to understand. The investors preferred less raw information but more relevant specific information for decision making. It is recommended that a two page executive summary with details of Profit, Dividends, EPS, Key ratios, Five year summary results along with a brief forecast and outlook for the next period be given. A brief review of the performance may also be included.

The study on voluntary disclosures thus indicates that mandatory disclosures play a very important role for making companies disclose. Within the mandatory disclosures, companies disclose only on a need to know basis. The ownership structure and pattern plays an important role in disclosures. The results have some implications for policy makers and also companies that are poor in disclosures. It is recommended that certain items of disclosures be mandated in the absence of voluntary disclosures by firms.

**Table 5.1:: Summary of the Disclosure Index Scores**

Disclosure Items	Mean		Standard Deviation		Median		Maximum	Minimum
	Score	%	Score	%	Score	%	%	%
Overall Disclosures	21.21	29.43	8.86	12.31	19.83	27.54	72.06	6.94
Strategic Information	11.33	43.60	4.10	15.71	11.00	42.31	84.62	11.54
Non Financial Information	5.23	19.40	4.10	15.04	5.00	18.52	73.08	0.01
Financial Information	4.70	24.61	2.58	13.58	18.50	21.10	68.42	5.26

**Table 5.2: Disclosure index scores on different information**

Items	Average Percentage of companies disclosing information.
<b>PANEL A: STRATEGIC INFORMATION</b>	
Corporate General Information	17.4
Statement of Strategy and Objectives	72.6
Research and Development	59.2
Future Prospects	13.5
Others	44.8
<b>PANEL B: NON FINANCIAL INFORMATION</b>	
Directors Related Information	16.0
Employee Information	14.7
Social Policy Statements	43.2
Value Added statements	11.2
Others	20.4
<b>PANEL C: FINANCIAL INFORMATION</b>	
Competition and Market Share Details	26.0
Financial Review	
Ratio Analysis	40.6
Financial History	74.4
Others	10.5

**Table 5.3: Descriptive Statistics**

Variable (n=86)	Market Capitalisation*		Ownership (%)		FII (%)	
	Mean	Median	Mean	Median	Mean	Median
<b>All companies</b>	4526	1889	49.20	49.42	9.17	6.49
<b>Ownership Pattern</b>						
Government Companies	5152	3858	72.08	71.79	5.26	2.21
Multinational Affiliations	4721	1921	55.50	58.70	6.16	3.02
Others	4291	1587	40.45	36.70	11.30	7.82
<b>Industry</b>						
Hi Technology Service industry	7481	4190	43.72	41.77	16.36	11.57
Chemical and Pharmaceutical	2315	1317	53.84	51.31	5.87	2.40
Others	4248	1289	48.61	46.67	8.06	7.04
*Market Capitalisation in Rs. Crore						

**Table 5.4: Pearson Correlation coefficient results**

	DISCIN	STRATIN	NONFIND	FININD	MCAP	OWNP	OWNMN	OWNG	FII	INDSERV	INDPC
MCAP	.404***	0.189*	.489***	.309***							
OWNP	-0.21**	-0.194*	-0.093	-.254***	0.043						
OWNMN	-0.161	-0.087	-0.059	-.318***	-0.105	0.18*					
OWNG	0.008	-0.176*	0.193*	0.007	0.187	.513***	-0.235**				
FII	.367***	.362***	0.174	.413***	.375***	-.434***	-0.168	-0.182			
INDSERV	.319***	.384***	0.188	0.179*	0.202*	-0.12	-0.111	-0.13	.360***		
INDPC	-0.193	-0.134	-0.166	-0.176	-0.075	0.126	.299***	-0.14	-0.172	-0.237**	
AUDBF	-0.074	0.042	-0.124	-0.135	-0.091	0.084	.443***	-0.222**	0.019	0.141	.245**
AUDBI	0.028	-0.003	0.064	-0.006	0.037	-.233**	0.039	-0.168	0.038	-0.122	-0.066
n= 86											
	***	Correlation is significant at the 0.01 level (2-tailed).									
	**	Correlation is significant at the 0.05 level (2-tailed).									
	*	Correlation is significant at the .1 level									

DISCIN = Overall Disclosure Index, STRATIN= Strategic Information Index NONFIND = Non financial information index FIND= Financial Information Index; MCAP = Market Capitalisation OWNP = Ownership Pattern OWNMN = Ownership Multinational OWNG = Ownership Government FII = Foreign institutional investor holding INDSERV = Service Industry INDPC = Industry Pharmaceutical and chemical AUDBF = Audit Firm with foreign affiliations AUDBI = Big Indian Audit firms

**Table 5.5: Regression results**

<b>PANEL A: Regression Results of Total Disclosures</b>							
<b>VARIABLES</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
Adjusted R2	0.196	0.157	0.148	0.198	0.203	0.17	0.144
F Statistics	11.351	8.93	8.367	11.522	11.852	9.721	8.168
Significance	.000	.000	0	.000	.000	.000	0.001
<b>Variables</b>							
Market Capitalisation	0.414*** (4.240)	0.391*** (3.908)	0.417*** (4.090)	0.31*** (2.956)	0.354*** (3.579)	0.392*** (3.952)	0.4*** (3.974)
Ownership Pattern	-0.228** (-2.338)						
Multinational Affiliation		-0.119 (-1.193)					
Government Companies			-0.07 (-0.687)				
Foreign Investors				0.251** (2.399)			
Industry (Service)					0.248** (2.511)		
Industry-PC						-0.164* (-1.655)	
Auditors- Big (F)							-0.038 (0.373)

t values are given in the parenthesis

\*\*\* Significant at P<.01 \*\* Significant at p<.05 \* Significant at p<.1,

**Table 5.5: Regression results**

<b>Panel B: Regression results of strategic information</b>							
<b>Variables</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
Adjusted R2	0.054	0.017	0.06	0.114	0.14	0.027	0.016
F Statistics	3.435	1.742	3.69	6.448	7.937	2.191	1.694
Significance	0.037	0.181	0.029	0.002	0.001	0.118	0.19
<b>Variables</b>							
Market Capitalisation	0.198*	0.182*	0.23**	0.062	0.116	0.18*	0.194*
	(1.872)	(1.682)	(2.145)	(0.561)	(1.132)	(1.678)	(1.799)
Ownership Pattern	-0.202						
	(-1.914)**						
Multinational Affiliation		-0.068					
		(-0.63)					
Government Companies			-0.218**				
			(-2.039)				
Foreign Investors				0.339***			
				(3.078)			
Industry (Service)					0.361***		
					(3.513)		
Industry-PC						-0.121	
						(-1.124)	
Auditors- Big (F)							0.6
							(0.552)

t values are given in the parenthesis

\*\*\* Significant at P<.01\*\* Significant at p<.05\* Significant at p<.1,

**Table 5.5 : Regression results**

<b>PANEL C: Regression results of Non Financial Information Disclosure</b>							
<b>Variables</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
Adjusted R2	0.234	0.22	0.231	0.216	0.229	0.238	0.227
F Statistics	13.968	13.02	13.794	13.026	13.621	14.261	13.47
Significance	0.000	.000	.000	.000	.000	.000	.000
<b>Variables</b>							
Market Capitalisation	0.494*** (5.194)	0.488*** (5.066)	469*** (4.846)	0.493*** (4.771)	0.47*** (4.832)	0.479*** (5.044)	0.481*** (5.027)
Ownership Pattern	-0.114 (-1.203)						
Multinational Affiliation		-0.007 (-0.07)					
Government Companies			0.105 (1.087)				
Foreign Investors				-0.011 (-0.108)			
Industry (Service)					0.093 (0.958)		
Industry-PC						-0.131 (-1.376)	
Auditors- Big (F)							-0.08 (-0.834)

t values are given in the parenthesis

\*\*\* Significant at P<.01 \*\* Significant at p<.05 \* Significant at p<.1,

Table 5.5: Regression results

PANEL D: Regression results of Financial Information Disclosures							
VARIABLES	1	2	3	4	5	6	7
Adjusted R2	0.147	0.158	0.076	0.179	0.088	0.098	0.085
F Statistics	8.32	8.99	4.51	10.24	5.1	5.61	4.969
Significance	0.001	.000	0.014	.000	0.008	0.005	0.009
<b>Variables</b>							
Market Capitalisation	0.321***	0.279***	0.319***	0.18*	0.285***	0.297***	0.299***
	(3.197)	(2.785)	(3.005)	(1.693)	(2.69)	(2.88)	(2.873)
Ownership Pattern	-0.268***						
	(-2.67)						
Multinational Affiliation		-0.289***					
		(-2.89)					
Government Companies			0.053				
			-0.498				
Foreign Investors				0.345***			
				(3.256)			
Industry (Service)					0.121		
					(1.147)		
Industry-PC						-0.154	
						(-1.147)	
Auditors- Big (F)							-0.107
							(-1.032)

t values are given in the parenthesis

\*\*\* Significant at P<.01 \*\* Significant at p<.05 \* Significant at p<.1,