

# CHAPTER 1

## Introduction and Background

### 1.1 Introduction

Securities markets perform a crucial role in facilitating capital formation by linking the providers and users of funds in an economy.<sup>1</sup> They also stimulate economic growth by mobilising and channelising funds into the most productive activity.<sup>2</sup> Capital markets in India have witnessed considerable changes in the last decade. Their importance has increased due to a significant role they play in providing capital for the corporate requirements. If the markets have to function effectively they have to be efficient.

Capital markets can function efficiently only when they provide a level playing field to all the stakeholders. For this, information must be readily available to all the market participants. Quality information that is adequate, accurate and timely will help reduce the information asymmetry between the managers and the contracting parties. Given the securities markets' ability to influence economic development and the need for investor protection from frauds and other violations, regulatory authorities usually regulate the market through antifraud measures, merit standards, mandatory disclosures or a combination of these. Moving from a merit based to disclosure based regulation, requires changes in legal framework, accounting and auditing standards and codes of best practices. This dissertation examines the law and practices related to corporate disclosures in India and recommends actions to bring them to international standards.

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<sup>1</sup> This dissertation follows the reference style given in "A Brief Guide to Legal Research at National Law School", issued by National Law School of India University (1999). For a detailed discussion see; R. Levine, and S. Zervos "Stock Markets, Banks and Economic Growth", 88 (3) *American Economic Review* 537, 537-559. (1998). See also R. Rajan and L. Zingales, "Financial Dependence and Growth", 88(3) *American Economic Review* 559, 559-586 (1998)

<sup>2</sup> The role of securities market in the development of the economy is discussed in detail in: World Institute for Development Economic Research: Foreign Portfolio Investment in Emerging Markets, Study Group. Series no. 5 (1990); A. M. Sedaghat, Tagi Sagafi-nejad and G. Wright, "Economic Development and Securities Markets in Developing Countries: Implications for International Accounting Education", 29(4) *Journal of International Accounting*, 297, 297-315

Capital markets have many advantages over the traditional bank based financing system. In a bank based financial system, there would be excessive dependence on debts. This would mean high leverage, which can cause a distortion in the capital structure of a firm.<sup>3</sup> Debt financing can also put a strain on the financial institutions. Higher leveraging through debt financing and poor governance along with other factors may lead to a situation like the East Asian financial crises.<sup>4</sup> Capital markets provide long-term funds for new companies and for diversification of existing companies. They allow the risk and burden to be spread to a larger group of investors rather than to an entrepreneur bearing it alone. Capital markets also serve as a mechanism for pooling small savings for investments. The economic condition of falling interest rates has also attracted the investors to invest in the stock markets.

In advanced countries, capital markets developed early because the financing needs of business units expanded more rapidly than the means available for supporting their growth. In developing countries, capital investment needs are more pronounced, especially for the development of basic infrastructure facilities and promotion of industrial ventures. The development of securities markets would therefore be a priority for these countries. World over, financing methods are changing from traditional bank finance to liquid securities system. In the wake of liberalisation and globalisation, many factors have contributed to this changing financing pattern.<sup>5</sup> The Indian corporate sector is characterised by the co-existence of public, private domestic companies and multinational enterprises. Amongst the domestic companies there are large business houses and stand-alone companies. Indian companies are still dependent on debt financing. However, they are moving towards financing

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(1994); also R.K. Filer, J. N. Hanousek and F. Campos, "Do Stock Markets Promote Economic Growth?" <http://www.econwpa.wustl.edu:8089/eps/fin/papers/0012/0012006.pdf> (June 20, 02)

<sup>3</sup> The disadvantages of financing through short term financing see N. H. Hakansson, "The Role of a Corporate Bond Market in an economy and in avoiding crisis", Working paper, [http://papers.ssrn.com/paper.taf?abstract\\_id=171405](http://papers.ssrn.com/paper.taf?abstract_id=171405) (Jan 01, 2001)

<sup>4</sup> R.G. Rajan and L. Zingales "Which Capitalism? Lessons from the East Asian Crisis", 11(3) *Journal of Applied corporate finance* (1998) at 40 also J. R. Varma, "Indian Financial Sector Reforms: A Corporate perspective", 23(1) *Vikalpa: The Journal of the Indian Institute of Management* (1998), at 27

<sup>5</sup> These factors include, shifting from private and bank debt finance, to equity finance, privatisation of government owned businesses, growth of mutual funds and other institutional investors, cross-border investment, competition between the major exchanges to attract foreign listings, easier access to the international capital markets.

through equity similar to many other countries that are accessing the stock markets<sup>6</sup>. Further, divestment of government investments in companies in the recent years has resulted in very large companies being listed in the stock markets. The Indian capital market has witnessed lot of changes during the post liberalisation period. India has the highest number of companies to be listed in any one stock exchange and is amongst top five countries in terms of total number of listed companies. The number of issues through the primary markets has gone up. During the period 1999-2000, Rs. 25,539 crores has been collected from the initial public offerings. A new stock exchange was National Stock Exchange (NSE) was set up. Many new initiatives like the automated trading, has improved transparency and reduced the cost of transactions. However, corporate scandals both in India and abroad like the Enron Corporation, WorldCom and other stock market scams like 'vanishing companies' have shaken the investors' faith and confidence in the market.

If the capital market has to develop and flourish, investor confidence in the capital markets has to be restored. Otherwise, potential investors will be discouraged from investing in securities and this will have a negative impact on economic development.<sup>7</sup> Investors in such cases will demand assurances in the form of investor protection through the legal system. Investor protection laws and its enforcement will ultimately determine the financial development of a country. A study by Rajan and Zingales show that the financial development and the economic growth of a country are positively related to the legal institutions.<sup>8</sup> In a market, when investors are protected they would be willing to pay more for securities, which in turn will attract companies to issue securities and this will lead to development of the capital markets. Researchers show that countries that protect shareholders have a valuable stock market with large number of listed securities per capita, and a higher rate of initial public offering activity than

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<sup>6</sup> Though the banks continue to play an important financing role, there is a trend towards security markets. See International Monetary Fund, "International Capital Markets: Developments, Prospects and Policy Issues" (International Monetary Fund: Washington DC, 1992) also see, S.P.Pal, "The Stock Market Development and its Impact On The Financing Pattern Of The Indian Corporate Sector" Source: [www.nse-india.com/content/research/paper2.pdf](http://www.nse-india.com/content/research/paper2.pdf) (Nov 12, 2003)

<sup>7</sup> M.G. Warren, "Legitimacy in Securities Industry: The Role of Merit Regulation, 53 (1) *Brooklyn Law Review* 129 (1987)

<sup>8</sup> R. Rajan and L. Zingales, "Financial Dependence and Growth", 88 (3) *American Economic Review* 559, 559-586 (1998)

an unprotected market.<sup>9</sup> Academic literature also argues that liquid and strong securities markets develop only in jurisdictions that protect the rights and expectations of minority shareholders.<sup>10</sup> Investors' protection is important in countries where expropriation of minority shareholders by the controlling shareholders is widespread and the laws and regulations are inadequate coupled with poor enforcement of them.

Under ideal conditions, in which the economy is characterised by perfect and complete markets or equivalently by an absence of information asymmetry or other barriers to efficient market operation, a firm's disclosures are completely relevant and reliable and are reflected in the market value. However, in practice, ideal conditions do not prevail. Moreover, the uncertainty surrounding the future course of events combined with the separation between management and its ownership in most firms create two significant problems. The first problem relates with asymmetry of information i.e. the problem of adverse selection: when management or the firm, contracts with other stakeholders who do not have the same knowledge of the business. The other problem is moral hazard risk; with management taking actions that cannot be directly observed by shareholders and other contracting parties. Such actions could be beneficial to management but detrimental to the firm or its shareholders. Investors investing through the capital markets are looking for protection from these two problems.<sup>11</sup> The regulatory authority in such cases uses a combination of antifraud rules, merit standards and disclosure regulations to protect the investors. The antifraud measures are the minimum level of securities regulation. These operate through investigations, injunctions and prosecutions of the persons defrauding in the

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<sup>9</sup> R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Legal Determinants of External Finance", 52(3) *Journal of Finance* (1997) at 1131

<sup>10</sup> The seminal work of La Porta et al has established the existence of two rival structures of share ownership: dispersed ownership and concentrated ownership and that the structure of share ownership in a given jurisdiction correlates with significant differences in the legal protection provided to minority shareholders. See R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, 106(6) "Law and Finance", *Journal of Political Economy* 1113 -1155 (1998) also Coffee argues that the early development of a relatively autonomous and self-regulating private sector in some countries, better accounts for stock market development than do legal differences. Either way, law matters and minority legal protections can affect the value of shares J. Coffee, "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control", 111 (1) *Yale Law Journal* (2001) at 1

<sup>11</sup> Capital markets have inherent element of risk. Investors investing in these markets should be well aware of such risk. The protection of the investors is not against such risks. It may be difficult to regulate a genuine failure where risks and rewards exist.

markets. In a merit based system, the authorities or the administrators evaluate and set the norms for access to the capital markets. While in a disclosure based system the market is left to make its own decision and they are provided with sufficient information. The efficiency of a country's capital markets depends on the quality of its rules governing disclosure and corporate governance.<sup>12</sup>

Disclosure of information plays a very important role in the development of the capital market. Disclosures are needed for the efficient allocation of resources and any information differences can create conflicts between the market participants and can lead to a break down in the functioning of the capital market. Incorrect and inadequate disclosures will not only affect the investor but may also affect the function of the capital market as a whole, also called as the "lemons problem"<sup>13</sup> i.e. the existence of information asymmetry between the managers and other stakeholders. In the absence of information investors will make wrong choices and would undervalue some good firms and overvalue some bad firms. As a result, firms may not take up projects even if there is a positive net present value.<sup>14</sup> Full and fair disclosure along with comparable and reliable information allows investors to evaluate investment and monitor management activities, which is necessary for the development of efficient capital market. The value of disclosure has been well recognised, and the relationship between the amount of information available in the market place and the efficiency of the stock market has been analysed by many researchers. Disclosures along with other factors like audit facilitate flow of credible information between managers and investors and will help in the decision making process of the investor.

The agency problems arise out of different ownership structures. Corporate ownership structure is different between the world's advanced economies and the developing countries. Some countries' corporations are diffusely owned with managers firmly in control, while in certain other countries' corporations have concentrated ownership. In some countries family ownership

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<sup>12</sup> R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, " Law and Finance ", 106 (6) *Journal of Political Economy* (1998) at 1113; see also R. La Porta et al Supra note 9 at 1132

<sup>13</sup> G. Akerlof "The Market for `Lemons': Qualitative Uncertainty and the Market Mechanism", 84(3) *Quarterly Journal of Economics* (1970) at 488.

<sup>14</sup> S.C. Myers and N.S. Majluf, "Corporate Financing and Investment Decisions when Firms have Information That Investors Do Not", 13(2) *Journal of Financial Economics* 187,187-221 (1984)

is dominant while in some others the labour strongly influences the firm. Many countries like USA, Japan and in Western Europe, have converged in their economies, business practices, and standard of living but their corporate ownership structures have remained different and different degrees of ownership concentration and labour influence have persisted. In the UK and USA, large companies are listed in the stock markets and have dispersed ownership among institutional and individual owners. Thus, the concentration of ownership is not high and the proportion of control would be in proportion to the ownership. The Indian structure is the hybrid of the outsider-dominated-market-based systems of the United Kingdom and United States and the insider-dominated-bank-based systems of Germany and Japan. The corporate structure and issue of control is very important, as it is fundamental to the economic activity in a free market economy. Ownership of property is a central mechanism by which incentives are created for the efficient use of resources in these economies. The ownership structure of a company determines the way in which companies are controlled and the kind of agency costs they generate.

In a corporate form of organisation, the agency problem arises because the investors do not control or manage the firm in which they have invested.<sup>15</sup> Consequently, the agents (managers) have enough opportunities to expropriate the firm's wealth and act in their own self-interest rather than the interest of the shareholders who are too dispersed to control the management. Managerial mismanagement can take place in the form of very high executive compensation, pursuit of non-value maximising objectives, empire building through diversification, selling at below market prices to affiliates that are detrimental to the firm. La Porta et al., suggest that in large firms, separation of ownership from control is not the problem, but it is the potential for expropriation of minority shareholders by large controlling shareholders.<sup>16</sup> In case of concentrated ownership or ownership held by family members a different set of agency problems arise. The dominant owners have an opportunity to expropriate assets from the firm for their own benefit, rather than to get future

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<sup>15</sup>A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: World Inc, 1932)

<sup>16</sup> R. La Porta, F.Lopez-de-Silanes, A. Shleifer and R.Vishny "Ownership Around the World", 54(2) *Journal of Finance* 471, 471-517 (1999)

returns that might have to be shared with minority owners, a process known as 'tunnelling'.<sup>17</sup> Expropriation can occur in many ways. It can occur when funds are appropriated by the owners by paying themselves large dividends or high salaries, by making loans or investments in subsidiary companies set up by the owners, or by buying assets from these at inflated prices or selling assets at discounts, giving loans to owners at concessional rate, borrowing funds without any problem and with no penalty when they default on repayment.<sup>18</sup> Such transfer pricing, asset stripping and diverting activities may be legal but in effect, but as it benefits only a few, it may amount to 'looting'.<sup>19</sup> In many cases it is also possible that appropriation could have been practiced with impunity by undermining the state owned financial institutions with active support from the political establishment and the bureaucracy. Other firms that contracts with such firms may also suffer when the original firm eventually collapses. Investors in such a case may not be able to exit, as they may not get the right price for the illiquid stock they own.<sup>20</sup> As a result, capital may get diverted from more productive firms, choking off new entrants and slowing the growth in the economy without new investments. In a developing economy such form of expropriation is likely where there is poor accounting standards, lax regulation, and low penalties for abuse, the same weaknesses that also make asset stripping likely to the detriment of minority holders. For example, in Russia where the law and governance was weak, there was a substantial diversion of assets by managers of many privatised firms, which ultimately led to non-supply of external capital to the firms. Concentration of ownership by family run corporations may sometimes result in costlier financing, as investors may not be willing to fund these firms.<sup>21</sup> In an ideal setting where the corporate governance system is effective and the capital market is efficient the ownership structure

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<sup>17</sup> S. Johnson, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "Tunneling", *Working Paper No. 7523* <http://www.nber.org/papers/2000> (June 12, 02)

<sup>18</sup> E. Fama and M. Jensen, "Separation of Ownership and Control", 26 (2) *Journal of Law and Economics* 301, 301-325 (1983)

<sup>19</sup> Akerlof and Romer show that looting is likely when the expected future economic value of a firm is less than the amount that owners can currently pay themselves. Looting, as described by them, arises when a government guarantees a firm's debt obligations, such that owners can borrow heavily, extract funds from the firm, and default on the debt without penalty. G. Akerlof, and P. Romer, "Looting: The Economic Underworld of Bankruptcy for Profit", 2(1) *Brookings Papers on Economic Activity* 1-73 (1993) at <http://www.nber.org/papers/r1869> (Sep 03, 2001)

<sup>20</sup> P. Bolton, and E.L. Von Thadden, "Blocks, Liquidity and Corporate Control", 53 (1) *Journal of Finance* 1-25 (1998).

does not matter. In the absence of either one of them ownership structures will affect the firm in every way including the disclosures.

In an efficient market, the market forces play the role of monitors and reviews the firms. The fall in the value of shares or the threat of takeover will act as a deterrent to inefficient managers. Government will also ensure market competition exists and they function efficiently. Enacted laws and its enforcements are needed to prevent fraud, enforce contracts and define property rights. Regulations are needed to supplement enforcement through courts. Laws and regulations gain greater importance in the absence of an efficient market.

## 1.2 Corporate Disclosure Environment

“The life and blood of markets is information and barriers to flow of relevant information represents the imperfections in the market.” (Committee Report, 1992)<sup>22</sup>

Information is needed by various stakeholders for decision-making. Companies provide information through financial statements of a company viz. the Balance sheet, the Profit and loss account and the Cash flow statements, Management discussion analysis, Quarterly reports and other disclosures from time to time. Information can be both financial and non-financial in nature. This information is used by the stakeholders to assess the amounts, timing, and uncertainty of prospective cash flows and profit of the enterprise. Disclosures through the financial statements provide information about the economic resources of an enterprise, and how those resources have been employed. A large body of research has provided empirical evidence regarding the usefulness of financial information in investment decisions. Studies find that accounting earnings numbers are included in the set of information that is useful in forming capital asset prices.<sup>23</sup> Financial Statement information helps analysis of trends

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<sup>21</sup> M. Boycko, A. Shliefer, and R. Vishny, *Privatising Russia* (Cambridge: MIT Press, 1995)

<sup>22</sup> *Report of the Committee on the Financial Aspects of Corporate Governance*, 33 (London: Gee and Co, 1992)

<sup>23</sup> For example the studies of: R. Ball and P. Brown, “An Empirical Evaluation of Accounting Income Numbers”, 6(2) *Journal of Accounting Research* 59-78 (1968) also N.J.Gonedes,

and provides considerable insight into the cost, productivity, profitability and liquidity of the company. The financial statements have been designed keeping in view the various needs of the users. Non-financial information aids in understanding the financial information and is also useful for decision-making.

The Corporate disclosure environment can be categorised into two dimensions viz. structure and process. The structure refers to the various laws and regulations and the process refers to the information and communication between the firms and the stakeholders.<sup>24</sup> Information that is provided to the stakeholders can be mandatory i.e. enforced through regulation (structure) or the companies may give the information voluntarily (process). Mandatory disclosures are those enacted in the various statutes, the accounting standards and other rules and regulations, which are the minimum amount of information that a company has to disclose. Companies may on their own give additional information, termed as voluntary disclosures. This is more than the statutory minimum and improves the credibility and the usefulness of the reports. Whatever be the nature of disclosure, they must possess certain fundamental qualities to be useful to the decision maker.

### **1.2.1 Quality of Disclosures**

“The cardinal principle of financial reporting is that the view should be true and fair and the Board should aim for the highest level of disclosure consonant with presenting reports that are understandable and with avoiding damages to their competitive position. They should also aim to ensure the integrity and consistency of the reports.” (Committee Report, 1992)<sup>25</sup>

Companies have recognised that, if they want to attract long-term capital, they need to demonstrate transparency and timeliness in their communications with the market. The transparency and timely disclosure represents the quality or the standards of disclosures. Investor confidence and market efficiency depend on these transparent disclosures. In the United States for example, capital markets thrive because of the transparent information environment. Accounting and disclosure requirements in the United States are unique, resulting in greater

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“Capital Market Equilibrium for a Class of Heterogeneous Expectations in a Two-Parameter World”, 31(1) *Journal of Finance* 1-15 (1976)

<sup>24</sup> R. G Eccles and S.C. Mavrinac, “Improving Corporate Disclosure Process”, 36(4) *Sloan Management Review* 11-24 (1995): where two dimensions of the market function are discussed.

<sup>25</sup> *Supra* note 22 at 33

transparency and providing a highly effective corporate governance tool.<sup>26</sup> In terms of financial reporting, transparency in information can be achieved by giving the investors relevant, reliable, comparable and timely information. As defined by Financial Accounting Standards Board (FASB), 'Relevance' and 'Reliability' are of primary importance in the preparation of any financial statement. Relevant information must be capable of making a difference in a decision and process of the user thus it would include confirmatory quality and predictive ability. Above all the information must be given in a timely manner to be useful for decision-making.<sup>27</sup>

Reliable accounting information would mean, that the accounting measure should correspond faithfully with the real world phenomenon that it purports to represent. These measures should be verifiable and the measure should be neutral, that is, it is not predisposed to a certain purpose, action or consequence.<sup>28</sup>

The quality of disclosures can be achieved through establishment of standards. These relate to the accounting measurement standards and reporting standards, which are mandated, or they can be the voluntary standards set by companies themselves.

### **1.2.2 Mandatory Disclosures**

Business involves a wide variety of transactions across diverse industries. The financial statements of the company are the major source of information, which capture these transactions. The financial statements can never give the exact picture of the business; it will however give a fair presentation of the same if prepared based on certain accounting principles. The recent fall of companies like Enron Corporation and WorldCom have brought into the forefront the discussion on improving the disclosure standards because of the growing complexities of business like complicated financial instruments and complex organisational structures. Accounting transactions can be recorded more than one way in the books of accounts and standard setters may give only generic

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<sup>26</sup> L. Lowenstien, "Financial Transparency and Corporate Governance, You Manage What You Measure", 96(5) *Columbia Law Review* 1335-1362 (1996)

<sup>27</sup> Financial Accounting Standards Board, "Statement of Financial Accounting Concept No 2" *Original Pronouncement* (FASB: Connecticut, 1999) at 1022

<sup>28</sup> Surpa note 27 at 1022

guidelines. The lack of specifics allows accountants greater discretion in deciding how to account and justify various transactions. Investors are concerned about the reliability of the accounting information as managements use variety of techniques to boost their income.<sup>29</sup> This will make the financial statements very unreliable. If disclosures have to be reliable and credible then they must be regulated for accounting and reporting and must adopt internationally accepted accounting standards in the preparation of financial statements. These standards are referred to as the Generally Accepted Accounting Principles (GAAP/ Accounting Standards). Accounting principles and standards are the foundation on which the financial reporting is based. If accounting principles are not clearly understood by the preparers or by the users of information or by those who audit them, then the message conveyed will be imperfect hindering the decision making of the stakeholders. Deliberate bypassing of accounting standards under innovative methods will also lead to the same results. This in turn will affect the investors risk perception of the corporate performance and will deter a healthy growth of the markets. When the management does not provide proper information to the market then government will have to mandate and enforce disclosures. An unregulated accounting environment would become inefficient and government intervention and regulation would be necessary.<sup>30</sup>

The accounting and reporting regulations governing the corporate sector will be influenced by factors like the ownership structures that control the firm. For example, a dispersed ownership will have different governance problems as against problems faced by the concentrated ownership leading to different regulations. As per the "path dependence theory" prior ownership structures in an economy might affect the subsequent structures.<sup>31</sup> The governance pattern and therefore the regulations will also be influenced by the ownership patterns

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<sup>29</sup> I. Griffiths discusses a number of ways through which incomes can be boosted in I. Griffiths, *New Creative Accounting: How to make your profits what you want them to be* (London: Macmillan Press, 1996)

<sup>30</sup> N. Gonedes and N. Dopuch, "Capital Market Equilibrium Information Production and Accounting Techniques: Theoretical Framework and Review of Empirical Work", 12(Supplement) *Journal of Accounting Research* 48-129 (1974)

<sup>31</sup> L.A. Bebchuk and M. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" [www.law.harvard.edu/programs/olin\\_center/corporate\\_governance/papers/No.266.99\\_Bebchuk-Roe.pdf](http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/No.266.99_Bebchuk-Roe.pdf) (March 3, 2001)

that the country originally had. For instance, India had the Managing Agency system, which was also in vogue in UK. Company laws were formulated to control the managing agents and problems associated with them. The accounting and reporting standards will thus be influenced by these factors.

### **1.2.3 Voluntary Disclosures**

While law regulates the mandatory disclosures, companies often make voluntary disclosures in their annual reports. Voluntary disclosures can be classified as those relating to mandatory and those that are purely voluntary. Voluntary disclosures are regarded as those disclosures that are not governed by any statute or accounting standards, like the value added statement and the social and environmental disclosures. In voluntary related to mandatory disclosures, a company can give additional information to enhance the understandability of the information. For example, although 'management discussion and analysis' of financial condition and results of operations are mandatory, companies can give additional information through ratios to make it more meaningful to the users. Companies may provide voluntary information for variety of reasons. This has been researched in the last forty years, yet continues to intrigue the researchers. The advantages of voluntary disclosures can range from creation of good corporate image to reduction in the cost of capital. Voluntary disclosures are to be viewed with caution, as sometimes it may be self-serving. While the law regulates the mandatory disclosures standards, companies through self-regulation can bring about a change in the disclosures through voluntary disclosures.

### **1.2.4 Regulatory Environment**

The effective functioning of the capital market requires a set of institutions both formal and informal that can protect the market participants. While enacted laws and its enforcement through courts do exist, a good regulatory oversight system will work more effectively. The regulatory environment includes rules devised by authorities to govern disclosures but within a framework. The essential functions of the regulatory authority relates to accounting, prevention of self-dealings of the owner/mangers, ensuring adequate disclosure regulations and enforcement of these regulations.

Various government and self-regulatory organisations regulate and enforce mandatory disclosures. A vital part of the enforcement is the independent auditors who audit the accounting information. The auditors bring credibility to the accounting information, which increases the reliability of the reporting system. Auditors provide to the shareholders an external independent check on the financial statements prepared by the management.

While regulatory institutions are necessary, better disclosures and transparency can be achieved by voluntary codes like the ones imposed by the self-regulatory organisations or through corporate governance mechanisms. Corporate Governance, in a very broad sense, can mean a process of managing and controlling the activities, directions and performance of an organisation and practices that will ensure accountability to its suppliers of finance. Voluntary codes or good governance will imply aligning the behaviour of the management with that of the requirements of the owners especially the minority shareholders. The quality of disclosures ultimately depends on the various mechanisms that can enforce good corporate behaviour. The key players are the Board of Directors specially the independent Directors and the audit committee. The shareholders of a firm appoint the Board of Directors and this Board in turn monitors the management. When there are non-executive independent Directors on the Board, they will act as a check on the executive Directors. Having independent Directors on the Board may also reduce the information asymmetry problem. There is a view that if corporate governance has to succeed, then the institutional investors must play an active role in the entire process. Institutional investors by virtue of their large stockholdings would have greater incentives to monitor corporate performance since they also derive greater benefits of monitoring.

### **1.3 Need for and Importance of the Study**

There has been a significant development in terms of deregulation and liberalisation of the Indian economy in the last few years. Deregulation and liberalisation has made international investment possible in India. Foreign investments in developing markets are quite high and at the same time are very mobile. Foreign investors are demanding internationally competitive levels of

returns on their investments and will move away to markets and countries that give better returns. For Indian companies, liberalisation means a greater access to foreign funds and broader financing options, which will reduce the cost of capital in the long run. The flexibility in movement of capital investments will force the companies to perform well and also project a good reputation. If the Indian companies want to take the full benefit of these global developments and attract capital investments they need to adapt, harmonise and converge to international accounting and reporting standards.

Harmonisation of accounting standards and accounting practices is necessary as we move towards an integrated capital market. Differences in accounting measurement along with various other factors such as the impact of economic, cultural and institutional differences will impede the growth in the capital market. In order to respond to the significant growth in cross-border capital flows, IOSCO has sought to facilitate cross-border offerings and listings. For this IOSCO has assessed and recommended a core set of 30 internationally accepted accounting standards that could be used by incoming multinational issuers in cross-border offerings and listings. Hence, there is a need to compare this set of accounting standards with our own standards.

Transparency and disclosures have become an important agenda all over the world. Transparency of information essentially means that stakeholders have a right to know about how and what will affect their interest. In countries like the USA, UK and European Union regulators require organisations to disclose information that affects the public welfare.<sup>32</sup> In the capital markets disclosures are important for decision-making. The quality of disclosures in the financial reports to the investors become important as they provide relevant and reliable information for decision-making. Reforms in the areas of disclosure would help protect investors, which in turn will benefit the expansion of capital markets. Adequate disclosures will improve the efficiency of capital allocation and insulate the market from financial crisis.

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<sup>32</sup> For example disclosure system has been designed to reduce health and safety risk, minimise corruption, protect civil rights etc., Nutrition labelling on food products, disclosure of sources of funds for election campaigns are a few examples where regulators require disclosure of information.

In the recent years, global convergence of legal rules and regulations governing the capital markets are under consideration. International organisations have emphasised transparency through disclosures to create incentives for the business to minimise hidden financial risks to investors. For example, the international monetary fund has established financial disclosure requirement for countries seeking access to international capital market. The Basle committee on banking has established transparency principles for international banking. The World Bank has adopted disclosure standards for its borrowers. World Trade Organisation has given special importance to harmonising the accounting standards. International Organisation for Securities Commission (IOSCO) has also put great pressure on its members to follow its rulings. Hence, there is a need to study the legal rules and regulations and their enforcement, specific to the Indian context with a view to adopt the best practices. A comparative study of disclosure regulations of UK, USA and Germany is undertaken to understand the international perspectives.

Business environment is fast changing with developments in areas like mergers and acquisition, complex financial instruments and organisational form, large investments in research and development and increased knowledge based companies. In spite of considerable increase in disclosure regulations, investors are critical about the information given in the annual reports by companies. Financial and non-financial disclosures have not kept pace with the changing business environment and has resulted in less useful annual reports. Reported earnings do not convey all information needed for decision-making, which necessitates additional disclosures. Therefore there is need to study the disclosure regulations in the reporting system which will result in the efficient production and use of information to the benefit of all market participants.

Financial information is considered inadequate and does not contain valuable insights that management can provide for efficient decision-making. In such cases, companies give additional information voluntarily. Standard setters and regulators need to be aware that full disclosure may not arise voluntarily. A study of voluntary disclosures by companies would provide valuable insights to the standard setters and regulators in order to decide whether to impose

additional mandatory disclosures and areas where companies are voluntarily disclosing which need not be mandated.

There is an increased debate all over the world as evidenced by the setting up of various committees, for looking into corporate governance mechanisms.<sup>33</sup> Researchers have also studied the role of corporate governance in the performance and management of companies. Various committees have asserted the role of certain features of corporate governance in financial reporting. While, various studies investigate the association between different governance mechanisms and corporate performance<sup>34</sup> not many are available linking it to the quality of disclosures. Studies have found some relationship between the Board of Directors and financial reporting functions and recognised its importance in the corporate governance mechanism.<sup>35</sup> Indicative links between the audit committee and financial reporting has also been found.<sup>36</sup> However, not much empirical research has been undertaken relating the ownership structure to the quality of financial reporting. This dissertation examines the relationship between the ownership structure and the level of disclosures. Further, nature of ownership based on government, multinational and foreign institutional investor holdings, type of industry, place of listing, big auditors and their effect on the disclosure of a firm are also examined in this study. This study will fill the gap in understanding the relation between these variables and level of disclosures in listed companies.

Markets are fraught with problems like vanishing companies, lack of interest by domestic retail investors, multinational companies de-listing from stock exchanges and insider trading. In the recent years, accounting scandals of big companies have also questioned the reliability of accounting and auditing regulations. The regulators have to play an important supervisory role and

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<sup>33</sup> Some of the committees appointed in the recent years include the Cadbury Committee, Treadway Commission, Blue Ribbon Committee, In India these include the Kumaramangalam Birla Committee, Naresh Chandra Committee and the Narayan Murthy Committee etc.

<sup>34</sup> For a review of various studies see: D. Patterson, Review of Papers and Studies at <http://www.thecorporatelibrary.com/study/patterson.reviews.asp> (Sep 20, 2001)

<sup>35</sup> K. Keasey and M. Wright, "Issues in Corporate Accountability and Governance: An Editorial", 23(91A) *Accounting and Business Research* 291-303 (1993) and G. Whittington, "Corporate Governance and the Regulation of Financial Reporting", 23 (91A) *Accounting and Business Research* 311-319 (1993)

<sup>36</sup> K. S. Thompson and M. Wright, *Corporate Governance: Economic, Management, and Financial Issues* (Oxford: Oxford University Press, 1997)

formulate adequate regulations that that will protect property rights, prevent frauds and enforce contracts for a healthy development of the capital market.

In a market-based perspective, quality disclosures and good corporate governance help firms to attract capital and improve performance. In spite of these advantages, companies still do not report adequately or give additional information voluntarily. Sometimes companies may also misrepresent information that is needed for decision-making. It is seen that companies, report and follow only the bare minimum that is mandated by regulations. In such cases regulations i.e. a legal approach to governance and disclosures holds the key to investor protection. Rules and regulations and their enforcement (contrary to efficient market hypothesis) have a strong influence on the behaviour of the firms and ultimately on the corporate performance and growth. Recently, the 'Law and Finance' approach to corporate governance have brought out the role of legal and judicial institutions on the working of financial markets.<sup>37</sup> In their seminal work, researchers have empirically examined the fact that law and its enforcement by courts have reduced the agency cost arising from separation of ownership from control, which in turn encouraged the development of financial markets. In the US, the government has avoided direct involvement in the management of corporations and has indirectly provided good legal and institutional environment to encourage and support wealth-creating activities.

India is in a transition phase moving from a public sector dominated system to a market based system. We are also moving from a merit-based regulation to disclosure-based regulation system. In this context it is important that we study the disclosure regulations and its enforcements in order to have minimum regulations and strong market forces that will keep the checks and balances. Hence, this study assumes importance as it examines the present disclosure laws and regulations and the practices of companies. This study also explores the various enforcement mechanisms and their suitability to the Indian situation. This study will help in developing a framework for formulating the various disclosure regulations and the enforcement related issues. This will in

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<sup>37</sup> See La Porta et al Supra note 12. and also R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny “, Agency Problem and Dividend Policies Around the World” <http://econpapers.hhs.se/paper/fthharver/1839.htm> (July 14, 02)

turn bring the country's investor protection to best practice norms and create an environment that will foster development of efficient corporate governance structures, which will ultimately benefit the shareholders and society as a whole.

## 1.4 Objectives of the study

"Information is central to the operation of effective capital markets. Information given in the financial reports is necessary to reduce the risks and uncertainties that investors and creditors face. Over time, a financial reporting process that fails to meet the information needs of investors and creditors results in ineffective capital markets. Uninformed markets misallocate and misprice capital to the detriment of every one".<sup>38</sup>

Market participants interpret and use information disclosed by companies, to assess the performance and for decision-making. Accounting regulations require companies to provide investors with relevant and reliable information. Disclosures made by firms on account of regulations are termed as mandatory disclosures. Regulations include financial reporting requirements of the law, Generally Accepted Accounting Principles (GAAP) and stock market disclosure requirements. If these regulations are weak then firms can easily manipulate and not disclose relevant information. Weak accounting regulations will result in poor quality disclosures. Prescriptions like the accounting standards must keep pace with the business developments in many areas. The financial reporting information has not kept pace with the changes in the business environment. Regulation and its enforcement are also needed for a good disclosure environment as mere regulation with no enforcement is of no use. The main objective of this study is to examine the levels of disclosures or the standards of disclosures relating to regulation, company practices and recommend enforcement system to improve the overall disclosure environment. This research has three objectives as discussed below:

- **Disclosure environment: Mandatory Reporting and Accounting Standards**

The objective of this study is to examine the disclosure laws and regulations relating to reporting and accounting standards in India and

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<sup>38</sup> AICPA, Improving Business Reporting - A customer Focus, Comprehensive Report of the Financial Committee on Financial Reporting 38 (New York: AICPA 1993) This report is referred in the thesis as the Special Committee Report

compare it with United States, United Kingdom and Germany and the International Accounting Standards and to identify the gaps if any, and to bring the standards on par with the international standards. The objective is also to examine select disclosure practices of companies.

- **Disclosure environment: Voluntary Disclosure**

The objective of this study is to examine the level of corporate voluntary disclosures by Indian companies and to suggest ways to improve the same. Further, the study examines the relationship between the levels of voluntary disclosures to the ownership structure of the firm. Additionally, the size of auditing firm, size of the company and type of industry are also examined to understand the differences in disclosures levels. The objective of this study is to explore the overall effectiveness of the reporting system.

- **Disclosure environment: Regulatory Mechanisms**

The objective of this study is to compare the role and function of institutions that set and enforce laws and regulations. The standard setting process and the role of various institutions, regulatory steps initiated to enforce disclosure by different authorities will be explored so as to suggest ways to improve the same.

## **1.5 Research Methodology**

This study uses different methodologies for studying the disclosure levels of both mandatory and voluntary disclosures. The study uses a comparative approach to study the reporting standards between countries. It also uses the method of content analysis for studying the disclosure levels of Indian companies.

The disclosure requirements i.e. the reporting standards and the accounting standards are compared between India, UK, Germany and US by examining the relevant literature relating to disclosures laws in these countries. Comparison of International Accounting Standards is also undertaken. Disclosure practices of select Indian companies relating to the segment reporting and disclosures of related party information are examined through a content

analysis. Content analysis is a suitable method to conduct this study. It is a research method that uses a set of procedures to make valid inferences from a textual matter. This technique is used to examine the level as well as the subject matter of disclosures.

The level of voluntary disclosures is examined using a disclosure index. The list of items in the index is constructed based on the previous studies and recommendations by various committees and also through the study of annual reports of Indian companies. Annual reports of companies are then examined through a content analysis for three broad categories viz. strategic, non-financial and financial disclosures. Differences in the levels of disclosures are also examined. Factors affecting the voluntary disclosures are also examined in this research. Specifically the size of the firm, the ownership structure, the industry effects, and the size of the auditor firms' influence on the disclosures will be examined. The ownership structure will be further analysed based on multinational ownership, government ownership and foreign institutional ownership. For this a regression analysis is undertaken to test the influence of the various factors on the disclosure levels of the companies. A primary questionnaire survey is also undertaken to understand the effectiveness of disclosures and to study the investor's perception and information requirement in the annual report.

The research also undertakes a critical comparative study of the standard setting process and the enforcement procedures and remedies available to the investors for inadequate reporting. A detailed description of the methodology is given in the appropriate sections.

## **1.6 Chapter summary**

Development of the capital market helps in the overall economic growth of a country. Investors are a little wary of investing in the markets as a result of various corporate frauds and scams that have shaken the stock markets. To develop a strong market investor protection is necessary. Regulators provide protection through antifraud rules, merit based regulations and disclosure regulations. As we move towards the disclosure-based regime from the merit-based systems, it is necessary to study the overall disclosure environment for a

smooth transition. In a disclosure-based regime full, fair and timely information is provided to the investor backed by a strong institutional set up that will enforce the disclosure-based regulations.

The corporate disclosure environment consists of voluntary and mandatory disclosures. This relates to both reporting and accounting. While the mandatory disclosures are the bare minimum, companies also have to develop their own codes for voluntary disclosures. These are enforced through the legal and self-regulatory organisations.

There is a three-fold objective of the study. Firstly, the disclosure regulations (accounting and reporting) are critiqued and compared with that of the selected countries. Secondly, this study proposes to evaluate the levels of voluntary disclosures of select Indian companies. The objective is also to find the reasons that explain the differences. Thirdly, this study explores the role of regulatory institution in enforcing disclosures. The three objectives of the study will comprehensively cover the standards of disclosure regulation and practices related to the annual reports.

The remaining of the thesis is organised as follows. Chapter 2 describes the disclosure environment giving the theoretical and regulatory perspectives. The study examines the forces of demand that give rise to disclosures and the regulations that govern disclosures. It also develops the framework for the study and review available empirical evidences.

Chapter 3 discusses the development of accounting and reporting regulations in the USA, the UK and Germany. The mandatory reporting standards are compared between USA, UK and Germany and the International Accounting Standards. Certain reporting practices of Indian companies are also examined.

Chapter 4 discusses the differences in the accounting standards and compares the Indian accounting standards with those of US GAAP and International Accounting Standards through a comparative study of accounting standards between US GAAP and IAS.

Chapter 5 examines the voluntary disclosure practices of Indian companies. For this a set of disclosure checklist is compiled and the level of

disclosures of the companies in the BSE 100 is examined. Further, the various firm level determinants affecting the voluntary disclosures level are also analysed. These include the ownership structure, the type of industry, the size of the audit firm and the size of the company proxied by market capitalisation. Investors need for additional disclosures are also examined and the effectiveness of disclosures are also surveyed.

Chapter 6 provides a critical study of the standard setting and enforcement institutions in India. This chapter also examines the remedies available to the investors in the case of misreporting. The role of auditors in the disclosure process is also studied.

Chapter 7 summarises the results and discusses the policy implications based on the study. It also covers the limitations of the present study and areas for future research.