

## Chapter 2

# Disclosure Environment: Theory and Regulation

### 2.1 Introduction

Disclosure is defined in the dictionary as to 'make known' or reveal.<sup>39</sup> The word 'reveal' would mean to make public some thing that is not known previously. It would also mean making known what is not apparent.<sup>40</sup> Disclosure is defined in Black's Law Dictionary as "revelation or the impartation of that which is a secret or not fully understood."<sup>41</sup> This definition captures the essence of disclosure, meaning an open and frank narration of things in such a way that it is understood or recognised by the person to whom it is made. The quality of 'being understood' may be because there is no secrecy surrounding it, or because it is expressed in a clear way.

In securities law, disclosures would mean "the revealing of certain financial and other information believed relevant to the investors considering buying securities in some venture; the requirement that sufficient information be provided to prospective investors so that they can make intelligent evaluation of a security."<sup>42</sup> Although this definition refers to prospective investors, disclosures are needed even to the existing investors. Disclosure is also defined as a "method of protecting investors that relies on company disclosing and publishing information, which is then evaluated by the investors, their advisers and the press."<sup>43</sup> Thus for companies it would involve providing a full and frank account of the activities that is readily understood by market participants.

Companies incorporated under the Companies Act, 1956, can raise resources from the public and further the equity shareholders of the companies enjoy limited liability. This, however, has the potential to affect the interest of the

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<sup>39</sup>"Disclosure", 130 *The Oxford Dictionary* (New Delhi: Oxford Press, 1999)

<sup>40</sup> "Disclosure", 562 *The Law Lexicon, The Encyclopaedic Law Dictionary* (2nd ed., Nagpur: Wadhwa and Co., 2002)

<sup>41</sup> "Disclosure", 417, *Blacks Dictionary of Law*, (5th ed., West Publishing company 2001)

<sup>42</sup> "Disclosure", *Supra* note 40 at 562

<sup>43</sup> "Disclosure", 126 *Oxford Reference, A Dictionary of Law*, (3rd ed., Oxford: Oxford press, 1994)

creditors and other stakeholders. Companies therefore have a duty to disclose information to its stakeholders. Quoting Sealy, "It has been recognised that the price which companies should pay for the privileges of incorporation and limited liability should be a fair degree of openness and publicity about their affairs. The Companies Act is based in that philosophy."<sup>44</sup> The goal of any disclosure requirements is to reduce uncertainty and narrow as much as possible the reasonable range of values for the company that might be inferred from its reported results.

A good disclosure system acts like a signal generating mechanism that is intended to clearly reveal the state of the things. It is a method, which regulates the conduct of Directors and Promoters (through fiduciary principles or by statutory provisions) to disclose to the company any relevant information.<sup>45</sup> Corporate disclosure is also regarded as an important aspect of good corporate governance. The term disclosure has a wide treatment under law for the dissemination of information.

Companies disclose information to stakeholders through various ways from time to time:

- At the issue stage, when there is an initial public offering, the prospectus is the first source of information to the investors, about the company.
- Subsequently, they receive information through the Annual reports that includes the three financial statements of a company viz. the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement along with the Report of the Directors and other financial and non-financial disclosures.
- Other continuous disclosures are made through the quarterly and half yearly results. Certain price sensitive information is required to be disclosed.
- In addition to these, companies make presentation to the analysts, have conference calls and disseminate more information to major lenders, rating agencies, industry experts and the press.
- Companies also file information with the Registrar of Companies and other regulatory agencies, which become public documents in many cases.

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<sup>44</sup> L. S. Sealy, *Cases and Materials in Company Law* 585 (London: Butterworths 1996)

Information that is disclosed is a combination of both financial and non-financial qualitative information that helps in decision-making.

While firms disclose information, do these information have any impact on the capital markets and the prices of the securities i.e. Do disclosures have information content and are they value relevant? Disclosures have value only if it gives additional information to investors that may lead to a change in the decision-making.<sup>46</sup> When investors act on such information, then over a period of time the prices in the markets will be affected. Various studies suggest that different disclosures made by the firms have information content. The earliest of studies, by Ball and Brown found that accounting earnings numbers are value relevant and have information content.<sup>47</sup> Ball and Brown investigated the annual earnings announcements and empirically found that accounting earnings reflect factors related to stock prices and therefore have information content. Various disclosure studies provide evidence that share returns are associated with the release of firm-specific news. For example, information disclosed in the press about research and development projects have significant impact on the stock market.<sup>48</sup> Managements release earnings forecast numbers. These disclosures are considered reliable by the investors and hence have information content.<sup>49</sup> Having information content would mean that disclosures have some value to the users. The information provided to the investors may either be regulated or the company may give the information voluntarily.

In this chapter we develop a broad framework of the study and consider the existing regulations on disclosures. The remaining of the chapter is organised as follows: Section 2.2 looks into the corporate disclosure environment and discusses the disclosure framework. The need for disclosures and quality of disclosure are discussed in the sections 2.3 and 2.4 respectively.

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<sup>45</sup>"Disclosure", Supra note 43 at 126

<sup>46</sup>M. Bromwich, *Financial Reporting, Information and Capital Markets* 211 (London: Pitman Publishing 1992)

<sup>47</sup> R. Ball and P Brown, "An Empirical Evaluation of Accounting Income Numbers", 6 (2) *Journal of Accounting Research*, 159-178 (1968)

<sup>48</sup>V. K. Narayanan, K.H. Pinches and D.M. Lander, "The Influence of Voluntary Disclosed Qualitative Information", 21(7) *Strategic Management Journal* 707-722 (2000)

<sup>49</sup> G.B. Waymire and G. Pownall, "Additional Evidence on the Information Content of Managerial Earnings Forecast", 22 (2) *Journal of Accounting Research* 703-718 (1984) see also S. Penman, "An Empirical Investigation of Voluntary Disclosure of Corporate Earnings Forecast", 18(1) *Journal of Accounting Research* 132, 132-160 (1980).

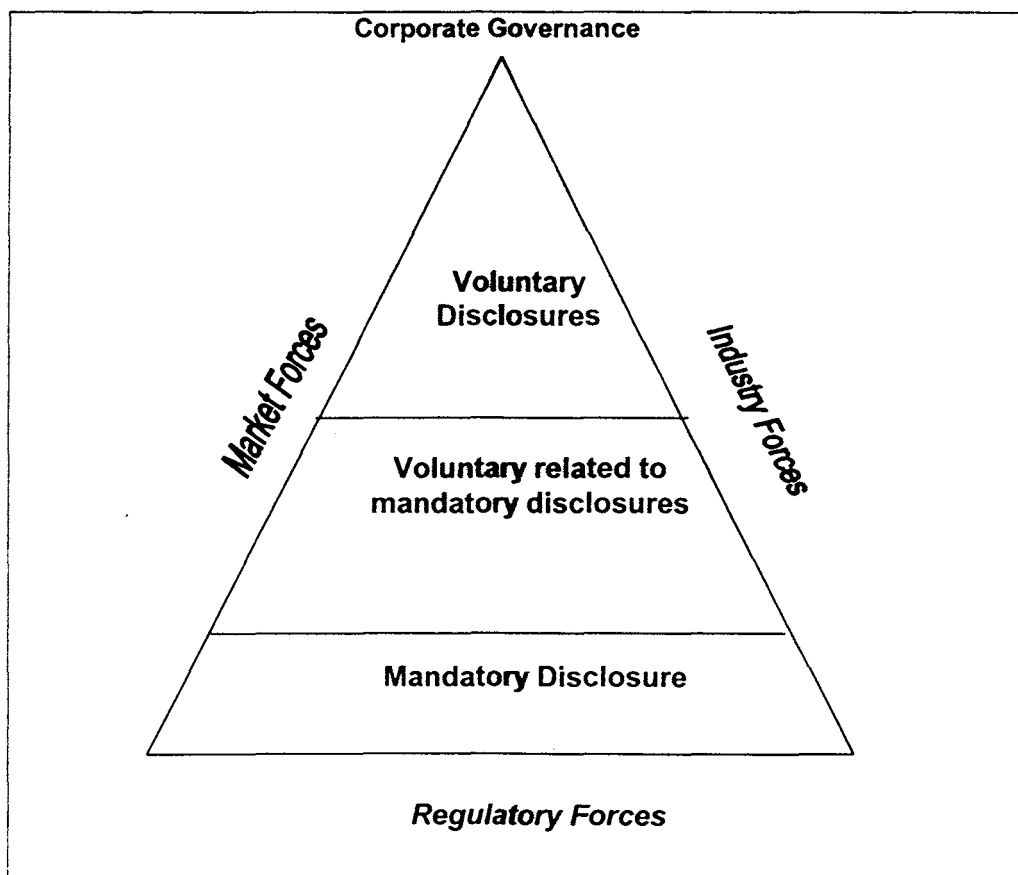
The need for standards in disclosures are examined Section 2.5. Disclosures can be broadly classified into mandatory and voluntary disclosures. Theoretical perspectives and legal requirement of mandatory disclosures are discussed in Section 2.6. Voluntary disclosures are discussed in Section 2.7 and Section 2.8

## 2.2 Corporate Disclosure Environment

The corporate disclosure environment is a function of many forces as depicted in Figure 2.1.

A company's disclosure can be broadly categorised into three levels. At the lowest level the mandatory disclosures are governed by law or are required by various regulatory authorities. Regulations in a country consist of enacted statutes, administrative guidelines and orders, and judicial decisions.

**Figure 2.1 Firms Disclosure Environment**



Mandatory disclosures are evolved over a period of time having regard to

certain practices considered not acceptable to a fiduciary position. An example of the mandatory disclosures is the report of the Board of Directors as required under the Companies Act.

The next is a set of voluntary disclosures but these are related to the mandatory disclosures. Companies are required to disclose minimum information, which is mandated by law. Even in the mandatory disclosure like the Segment reporting, companies may give the bare minimum information, or they may volunteer to give a larger view of the business, which will enhance the usefulness of the segment information disclosed. For example, in the Software Industry a company may call themselves 'single segment' or give additional information on segments based on business verticals or customers.

At the highest level are the voluntary disclosures. These are given voluntarily by the management and are not required under any laws or regulations. An example is the information on brand valuation or the value added information provided by some companies.

Regulations require firms to abide by the laws, making it mandatory to exert influence on management's decision to disclose. The voluntary and mandatory disclosure environment of a company is influenced by factors such as the market forces, industry forces, cost of disclosures and regulatory forces. The regulatory environment plays an important role in disclosures. Regulatory environment include various statutes, statutory audit and the legal system, which will enforce the various laws. A company's disclosures will determine the nature of corporate governance.

The process of getting useful information from companies to investors is a difficult one. First, standard-setters (and legislators) promulgate accounting literature to govern reporting; then, a company must interpret the literature and report its financials accordingly. The market then has to analyse and interpret the reported information. And, ultimately, investors have to make judgments based on the reports. The legal system monitors the entire disclosure environment so that the markets can function efficiently.

## **2.3 Need for Disclosures**

In a corporate form of organisation there are large numbers of shareholders or owners who are different from the people who are managing the business. This large public ownership of shares means that all the owners cannot take part in the management of the company. Hence, the decision making process in the corporate form is either entrusted to professional managers or to owners (promoters). The separation of ownership from management can result in conflicts between the various stakeholders and the people who manage the company. The conflicts between the stakeholders and the managers are more pronounced when the stakeholders do not get adequate information about the company. Disclosure in such cases serves as an efficient tool to induce managers to manage better, to prevent them from acting opportunistically, and to reduce the risks of fraud and manipulation. An important source of information about the company is the annual reports.

The annual report provides information about the performance of the company, conveys information on the organisational objectives, strategies, how the organisation meets its social and environmental responsibilities, and other information that may be needed by the stakeholders. Customers, employees', lenders, suppliers, managers, analysts and regulators need information about the company for different purposes.

Customers need information to judge the capability of a firm to supply them with goods and services for a long time. The employees would need information to judge the future prospects of the company and their own remuneration.

The lenders of the company are interested in evaluating the default risk of the company. They would like information about the company's position to repay the principle and the interest. They would also like to know if the management is taking any decisions, which may increase the risk of the lenders. However, the lenders have right to control the decision making of the company through the debt covenants. Based on the disclosures available the lenders will decide the rate of interest and the security they may require for securing their borrowings and protecting their own interests. Indian financial institutions as lenders, have

traditionally appointed nominee Directors to the Corporate Boards to look after their interest.

The government and regulatory agencies would need information for making policy decisions and also to control and regulate the behaviour of the companies. They will also need information for determining the national income and other statistics. The regulators can compel the companies to give the necessary information when they need.

Analysts are set of stakeholders needing information. They undertake peer reviews, give a global picture of the industry, discuss future cash flows and forecast earnings of a firm and also arrive at the firm's value. Analyst's forecasts have an important influence on stock prices.<sup>50</sup> Hence, they need disclosures to make more accurate forecasts of earnings. The shareholders of the company also need such expert analysis for buying and selling securities.

The shareholders of a company are the residual claimants against the assets of the company. They bear the maximum risk, as neither the capital nor the dividends need be given. Disclosure of information will help the shareholders in mitigating this risk to certain extent. Forewarned is forearmed, if investors and potential investors are enabled to find out all the relevant information about the company, it may serve as tool of investor protection. Investors need high quality information for making rational decision.<sup>51</sup> These decisions relate to either buying, selling or holding of securities. Unlike the commodities that are bought and sold like the manufactured goods, securities are not inherently valuable. They are mere documents and they derive their worth from the underlying assets and earnings of the issuer. An investor cannot simply look at the document and estimate its value like he can do in a product. To arrive at a proper value they would need information.

Investors need two kinds of information for decision-making: i) Information about the future also referred as forward looking information, to make forecasts and estimates for valuing their investments in the company and  
ii) Information about the working of the company to assess the stewardship of

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<sup>50</sup> P. Brown, G. Foster and E. Noreen, "Security Analysts Multiyear Earnings Forecasts and the Capital Market", 21 *Studies in Accounting Research* (Sarasota: American Accounting Association 1985)

the management and also to reduce the risk of fraud and manipulation.

While assessing the future of the company the investors need information about the resource allocation, which will enable them to make forecasts for future. Information is also needed for assessing the liquidity and operating capability of the firm. Investors require information to measure the risk and expected return from the investments they hold. The risk and return of a firm depends on many factors. These factors include

i) Macro economic factors like political stability, the growth rate of the economy, inflation rate, foreign currency fluctuations and the general policies of the government.

ii) Industry factors which are specific to companies in the industry like the competition and markets relating to the industry

iii) Company specific factors such as the financial performance, strategy adopted by the company, the product lines they are in and other features unique to a company.<sup>52</sup> Using this information the investors would be able to measure the risks and associated returns on their investment.

Shareholders will also need information about the working of the company to assess the stewardship of the management. Thus, accountability becomes the objective of a disclosure system. Good disclosures are effective way to make the management to manage better. As management has to report on the performance, "they will manage today, as they know the same will be measured tomorrow."<sup>53</sup> When the managers know that the stewardship (of investors money) and performance are under scrutiny through disclosures, they will be more diligent and competent. In a way disclosures of information will be a mechanism to control the managers. As expressed by Financial Accounting Standards Board (FASB) the purposes of disclosures are "to describe both recognised and unrecognised items and to provide a useful measure of unrecognised items and relevant measures of recognised items other than the measure recognised in the financial statements. Further, to provide information

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<sup>51</sup> D. E Kieso and J. J. Weygandt, *Intermediate Accounting* 8 (New York: John Wiley, 1995)

<sup>52</sup> M.S. Narasimhan, R.I Babu, and Y.S Reddy, "Corporate Disclosure Practices in India", *Report FIRE Project- IFMR* (1998)

<sup>53</sup> L. Lowenstien Supra note 26 at 1342

to help investors and creditors assess risks and potential of both recognised and unrecognised items.”<sup>54</sup> If financial disclosures do not serve the purpose they are intended to, then, they lose their reason to exist. Disclosures have to be of certain quality to be useful to the user. These are discussed next.

## 2.4 Quality of Disclosures

The disclosure standards are measured in terms of the quality of disclosures in this research. Disclosures are likened to abstract concept that cannot be measured directly.<sup>55</sup> Disclosures themselves have no characteristics on its own by which its quality can be determined. The quality of disclosures suggested in scholarly research is measured to determine whether the information disclosed in the annual report is adequate information for a purpose and whether the disclosures are informative and are reflected in the share prices. The quality of disclosures thus has to reflect the various abstract natures of disclosure and yet be useful.

In order to be useful various accounting bodies have identified certain qualities or characteristics of information. The four qualitative principles as given by the Institute of Chartered Accountants of India (ICAI)<sup>56</sup> are i) Understandability ii) Relevance iii) Reliability and iv) Comparability. These four principles apply to the financial statements prepared by the company, yet they hold good for any disclosures made by the company to its stakeholders. These act as a guide to the standard setters too. The qualitative characteristics of accounting information by FASB is given in Figure 2.2

Users need information to understand the nature the business of the company and the link between the various activities of the company and the effect of these activities on the financial performance of the firm. The financial reports can only be prepared with a view to the broad capabilities of the categories of users that can be expected to benefit from those financial reports.

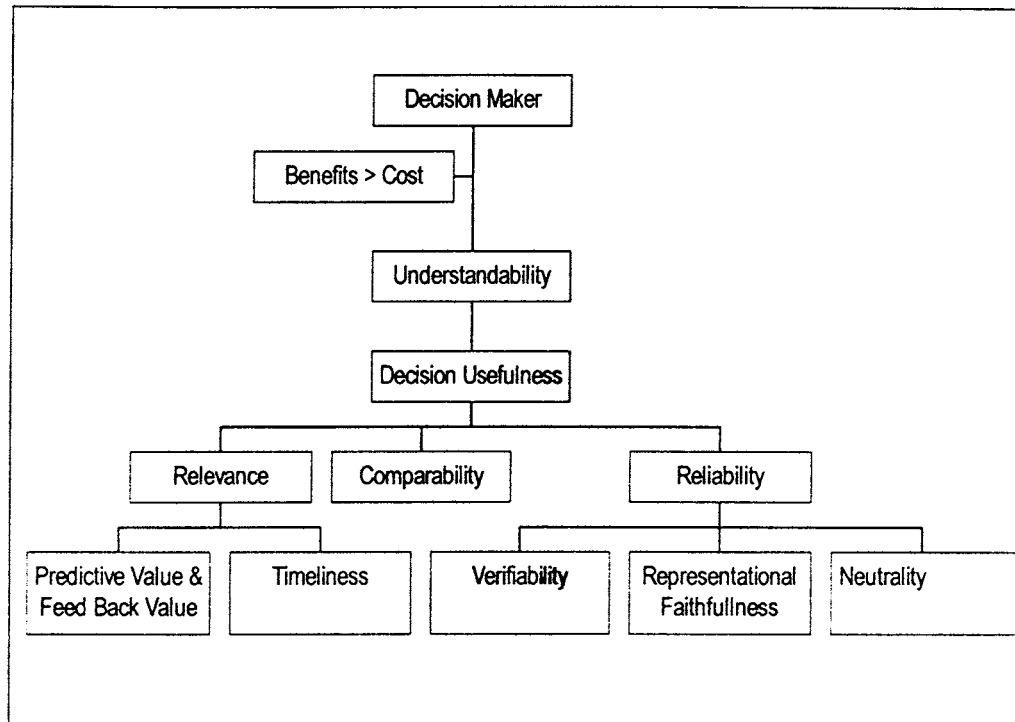
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<sup>54</sup> FASB, SFAS 105, *The original pronouncements*, (FASB: Norwalk: Connecticut, 1999) at Paragraphs 77-78

<sup>55</sup> R.S. Olusegun Wallace and K. Naser, “Firm Specific Determinants of the Comprehensiveness of Mandatory Disclosures in the Corporate Annual Report of Firms Listed on the Stock Exchange of Hong Kong”, 14(3) *Journal of Accounting and Public Policy* 326, 311 –368 (1995)

Not all investors have the ability to read or understand accounting or finance language. This may become an obstacle in decision-making. In making an assessment of those capabilities, users of financial statements can always take professional advice. It must be recognised that complex transactions and events cannot always be reported in simple or simplified terms without sacrificing relevance and/or reliability.

**Figure 2. 2 Qualitative characteristics of accounting information**



Source: Adapted from Financial Accounting Standards Board Concept Statement- 2

Financial reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices. The primary specific qualities of information are discussed next.

### **Relevant Information**

Information is said to be relevant for decision-making, when it will influence the users economic decision-making. The overall aim of a firm's disclosure activities is to increase investors' understanding of the firm's performance, its future outlook, and to ensure that participants interpret firm-

<sup>56</sup> Institute of Chartered Accountants of India, Framework for Preparation and Presentation of Financial Statements", *Compendium of Accounting Standards* 1-14 (New Delhi: ICAI 2002)

provided information in an informed manner. For this investors need relevant information. Information is said to be relevant if it has both predictive value and feed back value. Information loses its relevance if not given in a timely manner. Accounting information is historical information based on the transactions that have already occurred. This transaction relates to the economic resources of the company and how those resources have been used. The financial statements in a sense contain data about things that have already happened. The past data and events helps confirm earlier expectations of the investors. Relevant information in a financial statement is achieved when they report accurately and completely information on assets, liabilities, owners equity, cash flow and the results of operations.

The predictive information relates to the investors need to assess the future or forecasting the future. Investors must be able to assess the amounts, timing, and uncertainty of prospective cash inflows and profit of the enterprise. As seen in the history of mandatory disclosures and justification of mandatory disclosures the reporting was not for the purpose of decision making in the early 1950's. Quoting Staubus "No statement of any objective of accounting could be found in the documents prepared by the professional association' committee charged with responsibility for setting out important concepts and principals of accounting, such as the American Institute of Accountants' Committee on Accounting Procedure and the Executive Committee of the American Accounting Association, nor had any individual writer identified decision as the objective of accounting. It followed that no one had sought to build a theory, or a conceptual framework, on that basis."<sup>57</sup> The conceptual framework of the standard setting bodies now includes the decision usefulness as important criteria for disclosures. Information that an investor needs for predicting the future or for assessing the past is relevant information. An example is the disclosure of the accounting policies adopted by the company in preparation of financial statements and given in the annual report that, will help in understanding the quality of the earnings, based on the accounting policies followed by the company. Both present and

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<sup>57</sup> J. G Staubus, *The Decision Usefulness Theory of Accounting, A Limited History* 5 (New York: Garland Publishing Inc.)

forward-looking information are relevant and material as long as they may influence investment decisions.

Timeliness is an important quality of information that will make a difference in decision-making. If information is available after the decision is made it is not of much use. Financial report is increasingly criticised on the timeliness dimension. In the age of information technology, an user must get information at a faster speed and not after six months after the end of the accounting year as in the case of the annual report.

### **Reliable Information**

Financial statements are summarisation of activities of a firm. To be reliable they must portray the financial relationship of various activities of the firm. The three components of reliable information are verifiability, representative faithfulness and neutrality. Reliability of information is achieved when it is free from error and corresponds faithfully with the real world phenomenon that it purports to represent. That is, a mirror image of what has happened.

Verifiability implies consensus. Information is said to be reliable when another person using the same methods of verification can verify it and get the same result. Reliability also means that the measure should be neutral. Neutrality is akin to the fairness concept that is discussed later. Neutral reporting means that the information presented should not be biased in favour of one user to the detriment of others.

Reliability of information is ensured when there is an agreement between a measurement, and the activity or the item that is being measured. Having reliable information would mean that the disclosures are double-checked, which will reduce the judgement and bias of the management. Reliable information will result in higher level of confidence in the market. When the confidence in the market increases the investors level of investments will also go up. The reliability of information is therefore a key factor in disclosures. FASB states, "information should be reliable as well as relevant is a notion that is central to accounting. It is, therefore, important to be clear about the nature of the claim that is being made for an accounting number that is described as reliable."<sup>58</sup> The IASC

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Framework also supports relevance and reliability as attributes that make information provided in financial statements useful to users.<sup>59</sup>

### **Comparable Information**

The financial statements communicate the economic health of a company. For a proper assessment of information disclosed, stakeholders need benchmarks or standards for comparisons. Firms can be compared with others in the industry or even an international comparison. Comparison can also be made for a period. Comparisons are made on a quantifiable measurement of a common characteristic. Comparability requires similar events to be recorded in the financial statements in a same manner.

Management of a company must provide information that are relevant and reliable, which is accomplished when it is complete, clear, accurate and given in a timely manner. Relevant and reliable, comparable and understandable reporting is achieved through disclosure standards. These standards relate to measurement and reporting. In the next section the need for disclosure standards are discussed.

## **2.5 Need for Standards in Disclosures**

While disclosures are necessary for decision-making, these disclosures have to be of acceptable standards that are widely recognised as a model of authority or excellence. In any given field standards are acknowledged as good principles, practices, or guidelines for relevant areas.<sup>60</sup> Standards can be set for any functional area covering, accounting, disclosure and transparency, capital adequacy, regulation and supervision, governance, and risk management. Standards can also be set for institutions like banks, securities, insurance industries, and others. Standards are usually derived from a broad set of principles. Developing standards that are of high quality and acknowledged internationally will result in strong economic and financial system. Standards can

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<sup>58</sup> FASB, Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* Paragraph 58 (Connecticut: Financial Accounting Standards Board)

<sup>59</sup> IAS, *International Accounting Standards, Framework for the preparation and presentation of financial statements*, F-1 Para 24 (London: IASB 2002)

<sup>60</sup> Standing committee on the International Financial Standards and Codes, Report of The Advisory Group on Transparency in Monetary and Financial Policies (2000) at ii [www.reports.rbi.org.in/](http://www.reports.rbi.org.in/) (Sep 14, 03)

be differentiated by the degree of importance so that implementation becomes easier. Standards can cover a broad set of principles and rules with flexibility in implementation to suit a country's needs or they can be practices that show practical applications or they can be very specific guidelines or rules.

Standards in the accounting sense is defined by Van der Tas as "any financial reporting rule published by either government or a private standard setting body."<sup>61</sup>

Standards in any area perform the function of protection, comparison, and coordination.<sup>62</sup> Shareholders and potential shareholders will be protected from failures that may be costly. They strengthen the relevant regulations and enforcement and enhance transparency facilitating the overall development of the institutions and reducing inefficiencies.

Standards are a basis for comparison; a reference point against which other things can be evaluated; "they set the measure for all subsequent work."<sup>63</sup> Without standards the financial statements would be less useful to the user, who will then have to make their own standards for comparison<sup>64</sup> or in terms of accounting standards they will have to make costly translations between alternate accounting policies followed. Having standards will also reduce the managements discretion and the number of alternatives. Standards promote common understanding of the terms and contents of the financial statements, which will ensure comparability of information across companies. A user will understand the terms in the statement in the same way as the preparers. For example, if a term production cost is used in the financial statement it will mean the same wherever used.

The globalisation of capital markets has removed the geographical and financial borders. Countries growing rapidly may be in need of foreign funds, motivating regulatory authorities to regulate better disclosure standards. Indian

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<sup>61</sup> L.G. Van der Tas, "Measuring Harmonisation of Financial Reporting Practice" 18(70) *Accounting and Business Research* 157, 157-169 (1988)

<sup>62</sup> G. Baylin, L. MacDonald, and A.J. Richardson, "Accounting Standard Setting in Canada, 1864-1992: A Theoretical Analysis of Structural Evolution", 5(1) *Journal of International Accounting and Taxation* 113-131 (1996)

<sup>63</sup> "Standards" in <http://dict.die.net/standard/> (November 15, 2002)

<sup>64</sup> AICPA, "Improving Business Reporting -- A Customer Focus: Meeting the Information Needs of Investors and Creditors: A Comprehensive Report of the Special Committee on Financial Reporting", 3 (New York, AICPA 1994)

companies are tapping foreign markets for financing their business through Global Depository and American Depository issues. From the issuers' perspective, common accounting standards would reduce the burden of complying with different accounting regimes when raising capital in external markets. Standards provide a baseline for multinational companies to monitor inter-office financial performance. Having a single international accounting language would mean reduction in the market uncertainty and investment risk that would translate into a lower cost of capital for issuers.<sup>65</sup> Research finds that lack of proper use of financial reporting standards in some economies hindered transparency in financial statements of banks and firms, resulting in financial crisis in some Asian Countries<sup>66</sup>. Studies show that harmonisation of a countries accounting standards with foreign accounting standards can have advantageous effects on the performance of the capital markets specially with reference to the price informativeness and trading volumes.<sup>67</sup> Internationally comparable disclosure standards will have a salubrious effect on the capital markets.

Standards will encourage neutral and unbiased reporting, which will build credibility in the market for companies. When standards are established the audit of information becomes easier. Standards also help in retrievability of information by organising data according to a framework.<sup>68</sup>

Standards can be established through regulations or through voluntary codes adopted by companies. Standards can also be derived through international comparison of mandated disclosures and also through voluntary practices followed by companies. Standards can be set for both reporting of information and measurement of accounting transactions. The need for measurement and reporting standards stems from the quality of comparability information must possess.

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<sup>65</sup> S.Sunder, has estimated that a one percent decrease in the cost of capital for all NYSE-listed firms alone would generate savings in excess of US\$100 billion. S. Sunder, *Regulatory competition Among Accounting Standards Within and Across National Boundaries*, Working Paper, Yale School of Management [http://www.som.yale.edu/Faculty/Sunder/Regulatory\\_Regulatory\\_Competition.pdf](http://www.som.yale.edu/Faculty/Sunder/Regulatory_Regulatory_Competition.pdf) (Dec 11, 02)

<sup>66</sup> S Tripathi, "A Different World", 161(33) *Far Eastern Economic Review* (1998) at 49

<sup>67</sup> M.E Barth, G.Clinch and T Shibano, "International accounting harmonisation and global equity markets", 26 (2) *Journal of Accounting and Economics* 201-235 (1999)

<sup>68</sup> Recommendations made by the Jenkins Committee for improving business reporting were based on a user needs analysis. The investors stated that the most important thing they were looking for in the financial statements was an objective, comparable and auditable data. AICPA, Supra Note 38 at 3

Standards are not an end in themselves but a means for promoting effective accounting and other financial systems. They need to be continually evaluated in order to be relevant for the changing business environment. While countries adopt international standards, they must be suitably set within a country's overall economic and financial system taking into the stage of development and other factors into consideration. Implementation of standards involves a process of interpretation, application and enforcement. An effective legal environment is also essential for enforcement of the standards. When there are standards, and institutions that establish and govern the standards there will be reduction in the asymmetry of information, which will in turn promote the efficiency of the financial market.

For this thesis the term standards of disclosure includes both reporting and measurement (accounting) standards and relates to the annual report. In the next section reporting standards are discussed.

### **2.5.1 Reporting Standards**

Reporting standards are those that are related to the disclosure of both financial and non-financial information in the company's financial statements. For example, a standard may prescribe forward-looking statements for forecasting or inclusion of other non-financial information for informed decision-making.

The Special Committee Report that addresses various issues of investor and creditor concerns about the relevance and usefulness of business reporting supported the need for reporting standards.<sup>69</sup> Over a period of time there has been dissatisfaction with the usefulness of the company annual report as it has not kept pace with the business developments. Companies also do not give adequate information. Hence, there is a need for examining the reporting rules and practises to set better standards.

Reporting standards in this research refers to information given in the annual report, which are mandatory as well as voluntary and are relevant information. The various reporting standards related to the presentation of data are specified in the Companies Act 1956, The Listing Agreement and the Accounting Standards (AS). These are discussed in various sections of the

thesis. The accounting standards that are specific to reporting as prescribed by ICAI are given in Table 2.1

### **2.5.2 Measurement / Accounting Standards**

The annual report contains the financial statements along with the accompanying notes and other details of the company. The financial statements can never give the exact picture of the business. It will however be only a fair presentation of the business as the preparation of financial statements involves judgements of the management. Underlying the financial accounting system is the set of concepts, principles and procedures that have evolved over a period of time. These concepts, principles and procedures are collectively referred to as the Generally Accepted Accounting Principles. When these are mandated they are referred to as the Accounting Standards.

A business involves wide variety of transactions across diverse industries, and these transactions can be recorded and the income statement prepared using several different available alternatives. By changing from one alternative to another the financial results of the company may become entirely different. Some times the difference between the chosen method and the alternate method of accounting could be so different that the operating results may change not only in magnitude but also in the direction of the reported earnings.<sup>70</sup> This may not result in meaningful information, which will help the investor decision-making.

Various studies show that a number of factors affect the firm's accounting choice, like the size of the firm, the earnings based compensation plan for managers, the firm's debt equity ratio and income tax.<sup>71</sup> The accounting method selected by the firm may be to increase the reported income or it could be to reduce the income. Managers will lobby for and choose those accounting policies which decrease or defer tax payments, help secure favourable regulation, decrease political cost, decrease information production cost and increase managers bonus if it is linked to income.

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<sup>69</sup> The Special Committee Report was appointed to look into the reporting of business in the US. The recommendations and result of the finding are given in this report See Supra note 38)

<sup>70</sup> P. F. Pope and W. P. Rees, " International differences in GAAP and the pricing of earnings", 4(2) *Journal of International Financial Management and Accounting* 190-225 (1992)

Most of the accounting distortions such as off balance sheet financing, "window dressing", the presentation of debt as equity and the use of re-organisation provisions, were practiced in areas of accounting where there were no authoritative accounting standards and resulted in a variety of techniques to boost income.<sup>72</sup> The financial reports lose credibility when a series of surprise adjustments are made to earnings numbers.

The evolution of accounting in various countries has inevitably led to different practices and regulations. As the economic and the trading systems vary, the accounting methods and models differ from country to country. Many factors influence the accounting practices of countries. These factors range from the state control of an enterprise, the nature of economic activity, stage of economic development and stability of the currency and the taxation system. Political and economic system, the financial markets, the information technology and the legal setting in the country and the accounting profession also influence the accounting policies and thus the accounting standards in a country. Studies suggest that culture impacts the national modes of regulation and the accountants value system and their attitudes on the accounting system.<sup>73</sup>

Diversity in accounting practices can adversely affect a number of stakeholders who use the financial statements. Differences in the accounting methods/system require different measurement procedure for key items leading to different levels of disclosures. As a result, there will be differences in rules of recognition and valuation. Other stakeholders like, banks and financial institutions are also affected by the accounting diversity (although it is easy for them to get additional information from the company due to sufficient bargaining power). Most of the investors cannot compel or "negotiate" for the information. They have to rely on the mandated reporting.

At a very broad level accounting standards ensures that financial statements are:

- Comparable between companies by helping in narrowing the differences

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<sup>71</sup> M. Zmijewski and R. Hagerman, "An Income Strategy Approach to the Positive Theory of Accounting Standard Setting/Choice", 3 (2) *Journal of Accounting and Economics* 129-149(1981)

<sup>72</sup> I. Griffiths, *New Creative Accounting: How to Make Your Profits What You Want Them To Be* (London: Macmillan Press, 1995) discuss a number of ways of how income can be boosted.

<sup>73</sup> For these discussions see: S J Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally", 24 (1) *Abacus*: 1-15 (1988)

of accounting practices followed by the corporate sector.

- More informative in the ways in which the judgment is exercised in preparing the accounts.
- More reliable and consequently ensures their quality and information credibility.

The existence of accounting standards will determine the quality and the content of the financial statements.<sup>74</sup>

The process of standardisation of disclosure practices represents the most effective way of structuring the accounting framework based on past experience at that particular point of time. There is a need for having disclosure standards i.e. standards for measurement and reporting for mandatory and voluntary disclosures.

## 2.6 Mandatory Disclosures

“Regulation is a natural consequence of the underlying features of the market for accounting information, which are, in turn, determined by the system of corporate governance.” Further, “self-regulation will have inadequate enforcement power and this will lead to calls for legal backing from the state” i.e. public regulation.<sup>75</sup>

An important feature of the corporate disclosure environment is the regulation of flow of information to the investors. This can be termed as mandatory disclosures. Mandatory disclosures are minimum set of disclosures mandated by the law. Fox, terms mandatory disclosures as ‘required disclosure’ which he defines as “any obligation that requires an issuers management to provide on a regular basis, information that it might not be inclined to provide.”<sup>76</sup> Mandatory disclosures are founded on the notion that investors are protected by sufficient information to be able to make their own decision regarding their investments. The regulatory agencies prescribe the mandatory disclosures that require exact compliance. Sometimes only a broad guidelines are set rather than

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<sup>74</sup> J.Gaa “User Primacy in Corporate Financial Reporting: A Social Contract Approach” 61(3) *The Accounting Review* 435-454 (1986)

<sup>75</sup> G Whittington, “Corporate Governance and the Regulation of Financial Reporting”, 21(9) *Accounting and Business Research* 311-319 (1993)

<sup>76</sup> B.M. Fox, “Challenges to Corporate Governance: Required Disclosure and Corporate Governance”, 62 *Law and Contemporary Problems*, [/www.law.duke.edu/journals/62LCP](http://www.law.duke.edu/journals/62LCP) Fox at 115 (January 03, 2001)

prescribing an exact form. For example, in the case of Management Discussion and Analysis, only broad area of disclosure is specified and discretion is given to management to decide on the details and levels of information to be given. The Companies Act, 1956, the SEBI Rules, the Listing Agreements of the Stock exchanges and the Accounting Standards are the legislations and rules that describe the mandatory disclosures.

### 2.6.1 Need for Mandatory Disclosures

Why should firms be mandated to disclose information? Many arguments have been put forth for the need to mandate disclosures. These can be examined from the investor protection, providing value relevant information, public interest and to mitigate the agency problem perspectives.

#### 1. Investor Protection through Mandatory disclosure

Investors financing the companies acquire rights that are protected through laws and regulations. These rights include disclosure regulations and accounting standards, which provide them with information for decision-making. Securities laws, Takeover codes and Competition laws are some of the laws that set down investor protection regulations. Historically, securities regulation and mandatory disclosures have been enacted to ensure that capital markets are free from various exploitation that plagued securities transactions.<sup>77</sup> In the US too, one of the main reasons for introducing the Securities Act of 1933, was to deter market frauds which occurred preceding the depression.<sup>78</sup>

In any market, under the conditions of perfect competition the rules "caveat emptor" or let the buyer beware is a good safeguard against the improper practices by the producers or sellers of the goods. Under this rule, when the goods are substandard or expensive, the customers will reject them. Ultimately, the sellers of substandard goods will be driven out of the market. In terms of disclosures, market failures occur when there is large asymmetry of information between the buyers and sellers about the quality of the investments

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<sup>77</sup> R. L. Knauss "Disclosure Requirements: Changing Concepts of Liability", 24 (11) *Business Lawyer* (1968) at 33

<sup>78</sup> J. R. Doty, "The Role of Securities Exchange Commission in an International Market Place" 60(6) *Fordham Law Review* (1992) at 77-78 explains the reason for creating the Securities Exchange Commission, by the Congress to ensure that US Markets are fair and efficient.

leading to adverse selection and moral hazard.<sup>79</sup> In financial markets, transactions between buyers and sellers are characterised by information asymmetries. When information is not given to all market participants, some investors may become victims of other market participants, who may use their expertise to manipulate or conceal valuable information at the expense of some others. A company may provide false or misleading information about its status to make the company more attractive than it is. It may overstate its earnings. On the other hand it may underplay the bad news or not give information at all. Investors may also trade on information that may not accurately describe the intrinsic or fundamental value of the investments.<sup>80</sup> When investors are unable to observe the attributes of the securities that are offered for sale it may lead to many problems. Investors may not be able to distinguish between efficient and less efficient firms. Investors may buy the wrong securities at the wrong price or the wrong quantity. All this could be costly to investors and they will ultimately move away from the stock markets.

In situations where there are conditions leading to market failures, regulations are required to maintain the markets. In order to protect the investors, full and fair disclosures to all participants are necessary. Mandatory disclosures or minimum disclosures are necessary to bridge the information gap between the uninformed investors as against the informed investor and the management/ promoter. When firms operate in an environment with no regulations it may yield to many manipulative and deceptive activities.<sup>81</sup> Hence, there is a need for mandatory disclosures<sup>82</sup>, which will be instrumental in the efficient working of the capital market by controlling the levels of distribution of information to all participants in a timely manner.

## 2. Mandatory disclosures for providing relevant information

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<sup>79</sup> This problem of adverse selection is discussed by G. Akerlof, "The market of Lemons, Qualitative Uncertainty and Market Mechanism", 84(3) *Quarterly Journal of Economics* (1970)

<sup>80</sup> S.D. Corgill, "Insider Trading, Price Signals, and Noisy information", 71(4) *Indiana Law Journal*: 359, 355-417 (1996). This may also be the case, if the companies give false or misleading information about its status and working

<sup>81</sup> J.C. Coffee Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System", 70 (4) *Virginia Law Review* 717-753(1984).

<sup>82</sup> H. E Leland, "Quacks, Lemons and Licensing: A theory of Minimum Quality Standards", 87(6) *Journal of Political Economy* 1328-46 (1979), talks of imposing regulations mandating minimum standards of conduct

Disclosure of relevant information is necessary for predicting the future cash flows.<sup>83</sup> For predicting the future cash flows investors need both financial and non-financial information about the company. This information is needed to enable the prospective and the present investor to evaluate how well a company has fared in the past and how is their future performance going to be. Information of financial transactions can be linked to the role of financial markets as a forecasting device<sup>84</sup> or as an allocator of capital. If that is so, then the security prices become important and they have to be accurately priced. Therefore, cash flows become important. While information may be readily available whether such information is relevant and material to the investor for predicting the future cash flow is not known. Over the last few years, certain disclosures that help in influencing prices have been mandated. These include Management Discussion and Analysis and Segment reporting and other disclosures which provide value relevant information.

### 3. Public interest perspective of mandatory disclosure

Mandatory disclosure is also thought necessary from the public interest perspective. Accounting information is viewed as public interest disclosure as both the existing investor and the potential investors use this information. Investors may incur additional costs also referred as contracting cost as, they may be spending too much time to investigate the attributes of the securities that are offered for sale in the primary market if done individually. If information were mandatory and were readily available investors would increase their trading in higher quality securities that may improve the productivity in the economy. A mandatory disclosure system will reduce the social costs and losses while stimulating investors to use the securities market as a vehicle for savings. Quoting Coffee, "collectivisation of information minimises the social waste and increase the allocative efficiency of the securities market."<sup>85</sup> It follows that the provision of information to investors is a socially desirable institution, which has to be promoted for the overall benefit of the society. Therefore from the public interest perspective a regulatory framework must be set, to provide appropriate

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<sup>83</sup> FASB, in their objectives of the financial reporting state that such information should be provided to the investors that will help in assessing the net cash inflows to the firm.

<sup>84</sup> R. J. Gilson, R H Kraakman, "The Mechanism of Market efficiency", 70 (4) *Virginia Law Review* 549, 549-644 (1994)

disclosures.

#### 4. Mandatory disclosures to mitigate the agency problem

Some researchers justify mandatory disclosures to mitigate the agency problem. Agency problem arises when the investors in the business do not take part in the day-to-day management of the company. As a result of this the management and self-interested promoters may expropriate the funds of the company in various ways. This may happen through excess compensation or through decisions that may harm the investors.<sup>86</sup> The agency problem led to the first mandatory disclosures statutes in the United Kingdom and subsequently in the United States. The traditional model of mandatory disclosures looks into the past information as a method of detecting the breaches of fiduciary obligations of the managers.<sup>87</sup> Disclosures of accounting and other information will help in identifying how the firm's funds and assets have been used so that breaches of duties can be observed. An example is the detailed information in the Annual report regarding the management's compensation and the related party disclosures that companies have to make. The justification of mandatory disclosures is more pronounced in the case of the initial public offer, where the companies sell their shares to the public for the first time. Disclosure can help in reducing the cost of monitoring the self-interested promoters and managers and to safeguard against frauds perpetuated by the promoters.

Audited disclosures can reduce transaction cost and increase market liquidity by mitigating the incentive problems between the managers and the investor and between the informed and uninformed investors.<sup>88</sup>

In spite of justifications for mandatory disclosures, many researchers argue that the market should determine the nature and quality of disclosures. Positive research in accounting regulations indicates that a priori there is no clear justification for corporate disclosure regulations, rather it is the empirical question of cost and benefit of disclosures. Market rewards the high quality

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<sup>85</sup> Supra note 81 at 722

<sup>86</sup> M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", 3(4) *Journal of Financial Economics* 305, 305-360 (1976)

<sup>87</sup> P.G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problem", 62(4) *University of Chicago Law Review* (1995) at 1047

disclosures and penalises the lower one by increasing the firms cost of capital or by restricting the access to the capital market. The support for this argument has been 'The efficient capital market hypothesis'.<sup>89</sup> In an efficient market the price of securities fully reflect the information available of a company's business, its financial condition and management status.<sup>90</sup> Further the proponents of the efficient market also argue that disclosure regulations imposed by laws do not provide much benefits to the market participants.<sup>91</sup> Stigler argues that the Securities Act's new registration requirements had no important effect on the quality of new securities sold to the public.<sup>92</sup> This meant that law did not fulfil its role for investor protection through disclosures. To support this, Stigler conducted a test to compare how investors fared before (1923-28) and after the SEC (1944-1955) regulations introduced for new issues. The study found that the variance of price ratios had declined after the SEC's new regulation, but that was explained more because of SEC's policy of excluding risky companies rather than disclosure regulations. One could also infer that investors were able to assess companies better because of better disclosures system, which identified the risky companies. In the US, researchers also put forth an argument that companies were giving sufficient voluntary information and it was in the interest of the firm themselves to disclose material information.<sup>93</sup> If a firm did not disclose, they themselves would be the primary losers, as low quality companies will attract more funds because of greater disclosures than high quality firms that

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<sup>88</sup> W. H. Beaver, "The Nature of Mandated Disclosure", *Economics of Corporation Law in Securities Regulation*, (R.A Posner and K. E. Scott eds., London: Little Brown, 1989)

<sup>89</sup> E. Fama, "Efficient Capital Market: A Review of Theory and Empirical Work", 25(2) *Journal of Finance* (1970) at 383. Fama proposes that the price of the securities is always a full reflection of information available in an efficient capital market. When markets are efficient competition drives investors and analysts to obtain information of the firm from many sources other than the accounting reports itself. In an efficient market share prices are adjusted for such adjustments and the share prices reflect all publicly available information. This has the effect of saying that the securities disclosure regulation is unnecessary as it may result in duplicative and wasteful efforts.

<sup>90</sup> However, studies have also shown that prices do not fully reflect or adjust to all the available information and when information is noisy the market may not be able to aggregate all the information given. S. Grossman and J. E. Stiglitz, "On the Impossibility of Informationally Efficient Markets", 70 (3) *American Economic Review* 393, 393-408 (1980) and J. Ou and S.H. Penman, "Accounting Measurement, Price-Earnings Ratios, and the Information Content of Security Prices", 27 (3) *Journal of Accounting Research* 111-144 (1989)

<sup>91</sup> G. Stigler, "Public Regulations of the Securities Market", 37(2) *Journal of Business* (1964) at 117

<sup>92</sup> Supra note 54 at 124

<sup>93</sup> F.H. Easterbrook and D. R. Fischel "Mandatory Disclosure and the Protection of Investors 70(4), *Virginia Law Review*, 714, 669-715 (1984)

do not disclose. In such a case even low quality firms may mislead the markets by giving false information or omitting relevant information.

Mandatory disclosure system is thus necessary as they provide the investors with necessary information to make decisions. In the absence of mandatory disclosure researchers believe that some issuers would conceal or misrepresent information material to investment decisions and underwriting costs would be then become high. There will be less confidence in the securities market and neither state laws nor private association can ensure the optimal level of disclosure and civil or criminal actions would not ensure optimal levels of corporate disclosure.<sup>94</sup> Having mandatory disclosure or some form of coercive regulation will ensure efficient capital market in the best interest of the society.

## **2.6.2 Determinants of Mandatory Disclosures**

Mandatory disclosures in a country are affected by factors such as cost of disclosures, various statutes (Companies Act, 1956, the Listing agreement and Accounting standards) and the regulatory institutions. These are discussed in this section.

### **1. Cost of Mandatory Disclosures**

Traditional disclosure theories assumed no costs for disclosures. However, mandatory disclosures involve costs both to the companies and the regulators themselves. The cost of compliance of the mandatory disclosure would include costs of production of information, certification, dissemination processing of information and interpretation.<sup>95</sup> The market regulatory authority would also incur administrative and other costs in enforcing them. These costs would include the cost of development of the regulation, the cost of checking the compliance by the companies. Costs would also be incurred to enforce the regulations and litigation costs in case there is litigation. Not much empirical evidence is found on the cost benefit analysis. A few studies have examined the perception of costs and benefits of accounting regulations. For example, Butterworth and Falk used questionnaires to measure the perceived costs and

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<sup>94</sup> J. Seligman, "The Historical Need for a Mandatory Corporate Disclosure System", 9 (1) *The Journal of Corporation Law* 1-49 (1983)

<sup>95</sup> W.H. Beaver, *Financial Reporting an Accounting Revolution*, (New Jersey: Prentice Hall Inc 1989) at 182

benefits of Canadian accounting standard. Their conclusion was that respondents questioned the basis of desirability of the accounting standards to ask for detailed information.<sup>96</sup> Another study examined the corporate direct cost for publishing replacement cost data and found that in the year 1977, the total cost would have been 12 million dollars for all firms that needed to disclose information in the US.<sup>97</sup> While these are direct costs, indirect costs would include costs that company may incur when firms make changes in the economic decision due to changes in the regulation.

## **2. Disclosures Under the Companies Act, 1956**

The Companies Act, 1956 is the primary authoritative law for companies in India. The Act deals with registration and formation procedures, issues of securities, management of the company and those relating to accounts, audit and other matters. In terms of disclosures, Section 59 deals with the offer documents or the prospectus and the information that it should contain. Section 209 to section 223 deals with the financial statements and the books of accounts that a company must maintain. Disclosures are also to be made to the Registrar of Companies (ROC). Disclosures relating to the Directors interest in transactions and disclosures through the offer documents and the prospectus are others that are mandated.

### **i) Disclosures through offer document or the prospectus**

When companies issue securities through the markets, they have to disclose information through the offer document called the prospectus. The format and the content of the offer document have been given in the Schedule II of the Companies Act, 1956. Part I of the schedule contains disclosures regarding the basic details of the issue like the terms of the issue, the intermediaries connected with the issue, the purpose of the issue, the present business of the company the details about the management etc. Part II of the schedule gives disclosures regarding the consent of the Directors, the audited

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<sup>96</sup> J. E Butterworth and H. Falk, "Accounting Standards: Perceived Cost Benefit Relationships – A Survey", Working paper, University of British Columbia as quoted in S. Maijoor, "Cost Benefit Analysis and Accounting Regulation", Research in Accounting Regulation 61 (G.J. Previts ed., Connecticut: Jai Press Inc, 1994)

<sup>97</sup> C.W. Bastable, "Is SEC Replacement Cost Data Worth the Effort", 144(10) *Journal of Accountancy* 68-76 (1977)

financial statement of the company, details of purchase contracts, details of any revaluation to assets and details of material contracts of the company. The detailed analysis of the contents is beyond the scope of this study.

## **ii) Disclosure through the annual report**

Shareholders are entitled to receive information in the form of annual report every year. The annual report consists of the Balance Sheet, Profit and Loss Account, the Auditor's report, the Directors report and other information that needs to be attached. These are to be sent to the shareholder not less than twenty-one days before the annual general meeting (Section 219 (1)). The Copies of the annual report are to be filed with the ROC within thirty days from the date of the annual general meeting or if the annual general meeting is not held within thirty days from the latest day on or before which that meeting should have been held (Section 220 (1)). These documents then become a public document and any person can access them. The form and content of the financial statements has evolved over a period of time and these are discussed in the next chapter.

Section 210 (1) of the Companies Act, states that every company must lay before the annual general meeting: (a) the balance sheet as at the end of the period and (b) a profit and loss account for that period. The period is the financial year which can be more or less than a calendar year but cannot exceed fifteen months and with the permission of the ROC up to eighteen months. In effect, the annual report can be prepared up to eighteen months from the previous balance sheet date.

The term Balance Sheet is not defined in the Companies Act, however the form and content of the Balance Sheet is specified in Part I of Schedule VI. Balance sheet usually means a statement giving the financial position as at a given date. The Balance Sheet as stated in the earliest of cases of Official Liquidator, Karachi Bank vs. Shewaram, "the Balance Sheet represents the cumulation of the system of book keeping and should be a document setting out the true position of the business in such a manner as may be easily understood by men of business intelligence."<sup>98</sup>

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<sup>98</sup> Official liquidator, Karachi Bank Vs. Shewaram (1933) AIR 1933 Sind 103

The function of a Balance sheet was given by the Institute of Chartered Accountants of UK in front of the Cohen committee and stated so in the report as: "The function of the Balance sheet ... is to show the share capital, reserves (distinguishing those which are available for distribution as dividends from those not regarded as available) and liabilities of the company at the date as at which it is prepared and the manner in which the total monies representing them are distributed over several types of assets. A Balance Sheet is a historical document and does not as a general rule purport to show the net worth of the undertaking at any particular date of the present realisable value of such items as goodwill, land, plant and machinery except in the cases where the realisable value, is less than cost, does it normally show the realisable value of stock in trade." <sup>99</sup>

The Companies Act does not give the form of the Profit and loss account but give the contents as per Part II of Schedule VI. There is no requirement of the Cash flow statement as per the Companies Act. The details of Schedule VI and other disclosures are discussed in the next chapter. The disclosure requirement as laid down by the Companies Act is the minimum set of disclosure and companies can give additional disclosures if required. Part III requires the general business profile to be given.

Section 211 of the Companies Act, requires that the Balance Sheet and the Profit and Loss account of the Company must give a true and fair view of the state of affairs of the company as at the end of the financial year. The word 'true and fair' is not defined in the Companies Act; however, researchers and judiciary have interpreted the terms from time to time. The term 'true' means information that is not false but based on fact and conforming to existing situation. Information is also said to be true, when it agrees with rules and standards. In a way, one can say that the accounts have been drawn correctly from the books of accounts and they faithfully represent the underlying business activity. The term fair can be construed as that information which is free from discrimination and bias and in compliance with expected standard.<sup>100</sup> Practically the accounts should reflect the commercial substance of the company's underlying

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<sup>99</sup> A. Ramaiyya, *A Guide to Companies Act, 1956* (Nagpur: Wadhwa & Co, 1998) at 1580

transactions.

The true and fair view does not mean arithmetic accuracy but consist of three basic ideas; i) A legal residual clause ii) All independent concept and iii) Generally accepted accounting principles.<sup>101</sup> The legal residual clause means those circumstances not covered and foreseen by the situations identified in the legal document or the Act. The true and fair view as an independent concept refers to the notion of a higher objective (independent of accounting rules), which accountants and auditors are to see from a set of accounts. The third idea generates from the use of the generally accepted accounting principles.

The overall intent of the true and fair view construct is that information represents reality and is disclosed in an unbiased or a neutral way. This means that the accounting and financial reports reflect the current and real issues rather than the book figures they reflect. It would also mean that companies must comply with the accounting rules contained in the Companies Act and those in the accounting and financial reporting standards while communicating to the various users. All material facts regarding the company must be disclosed. There should be no misstatements and the assets and liabilities must be valued properly and the disclosures must not be misleading to the users. True and fair financial reporting should ensure a high quality of disclosures. While true and fair view is an important concept, Section 211(5)(v) of the act further states that a non-disclosure of an item, which need not be disclosed, does not make it a violation of the true and fair concept, in the case of a company any matters which are not required to be disclosed by virtue of the provision contained in Schedule VI or through a notification issued under subsections (3) or (4).

### **iii) Annual report of subsidiary companies**

Countries like the United States and the United Kingdom prepare only the consolidated financial reports. These reports present a total picture of the group. Section 212 requires that along with the balance sheet of the holding company the following documents have to be made out and attached to the balance sheet

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<sup>100</sup> C. Nobes and R.Parker, *Comparative International Accounting* 21 (New Delhi: Pearson Education Inc, 2002)

<sup>101</sup> P.Walton, "The True and Fair View in British Accounting", 2 (1) *European Accounting Review* 49, 49 -58 (1993)

of the holding company:

- Copy of the balance sheet of the subsidiary
- Copy of its profit and loss account
- Copy of the report of the Board of Directors and
- Copy of the auditor's report
- Statement of holding company's interest in the subsidiary company given in subsection (3); i.e. giving the extent of the holding company's interest in the subsidiary company, the net aggregate amount that is not dealt with in the company's accounts as it relates to the subsidiary's profit after deducting the losses or *vice versa* and the amount of profit or loss for the financial year and the previous financial year if dealt with or provided in the company's accounts.
- Additional statement, if the financial years of the subsidiary and the holding company do not coincide.

Consolidation of accounts was not mandatory till the year 2001. It was stated in the Company Law Committee report that, consolidation was not required as it was felt that information from the subsidiaries reports gave more information than a consolidated report and no additional information was derived from consolidation.<sup>102</sup> Although the Companies Act has not been amended, companies are now preparing the consolidated financial statements as result of the application of the accounting standards. From the financial year 2002, companies have to prepare the consolidated financial statements, which are submitted along with the annual report of the holding company. In effect, there will now be a consolidated accounts as well as holding company reports. Many companies have sought exemption from the Department of Company Affairs, from attaching the individual subsidiaries accounts in lieu of the consolidated accounts when circulating to the shareholders.

#### **iv) Director's Report**

The communication by the Directors on the financial performance of the company is an important source of information to the various stakeholders. This communication usually summarises the financial and non-financial information in a way intended to enhance the readers understanding of the company's

performance. It is the responsibility of the Directors to communicate to the various stakeholders in an honest and transparent manner the result of the operations of the company in both good and bad times. The report of the Board of Directors must present a clear and understandable picture of the company's position.

The objective of having a Director's report is to provide information on events or uncertainties known to management that would have a material impact on reported financial information. Such disclosure would assist investors in understanding a company's financial condition, changes in financial condition, and results of operations. As observed in the Cohen Committee report. "Director's report is a colourless document which do little to inform or educate the share holders."<sup>103</sup> Consequently in recent years additional disclosures have been mandated to make the report more useful to the users.

Section 217 of the Act requires a report by its Board of Directors (hence forth referred as Director's Report) to be attached to every Balance Sheet of the company.

This report should contain the following particulars:

- i) State of company's affairs (Sec 217 (1) (a))
- ii) The amount to be carried as reserves to the balance sheet (Sec 217 (1)(b))
- iii) Amount recommended for payment of dividend (Sec 217 (2)(c))
- iv) Any material events occurring between the end of the financial year of the company to which the balance sheet relates and the date of the report Section 217 (1)(d).
- v) The conservation of energy, technology absorption and foreign exchange earnings and outgo; 217 (1)(e). Details about the conservation of energy must include energy conservation measures and additional efforts taken for conservation of energy. For technology absorption, details such as specific areas where the company carries out research and development, the benefits derived from the research work, and efforts made towards technology absorption and production improvement and product development must be given in the specified formats for reporting.

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<sup>102</sup> See A. Rammaiyya Supra note 99 at 1682

<sup>103</sup> Supra note 99 at 1698

vi) Additionally, the report should deal with any changes that have occurred during the year in the nature of company's business, the nature of business carried on by the subsidiary and the changes in the classes of business in which the company has an interest, if these are material for understanding the state of affairs of the company.

vii) Section 217 (2A) requires the names and other particulars of employees who are getting a remuneration of a prescribed amount also indicating if they are relative of any Director or manager of the company. Many of the requirements of the Directors Report are derived from the Companies Act of the United Kingdom. For example, the Companies Act, 1967 (UK) required the remuneration of employees getting more than ten thousand pounds to be stated, which is similar to Section 217(2A) of the Act.

viii) Section 217 (2B) requires the Directors to state the reasons for the failure to complete the buy back of shares within the specified time.

ix) The Board must also give in its report fullest information and explanation for any adverse remarks or qualifications by the auditors (217 (3))

x) The Director's need to give a responsibility statement indicating that the accounts have been prepared as per the applicable accounting standards along with an explanation for material departures. The statement should also specify that the accounting policies are applied consistently and the judgements and estimates made would result in a true and fair view of the statements. The responsibility statement also indicate that the Directors had taken sufficient care for maintaining adequate accounting records in accordance with the Act for safeguarding the assets and for preventing and detecting fraud and other irregularities and that accounts are also prepared on the going concern basis. (Section 217 (2AA)).

#### **v) Disclosures of Directors dealings with the company**

Directors have expertise in business that can be harnessed to the company's advantage. However, because Directors are in a "fiduciary" relationship with the company, they must put the company's interests ahead of their own interest when a potential conflict arises. In cases where there is conflict of interest the Act provides for disclosures by the Directors.

The Companies Act requires that certain transaction of the Directors

related to the company must be disclosed to the Board and the shareholders. Section 299 provides that any Director who is interested in any contract or arrangement or a proposed contract or arrangement entered/to be entered by him on behalf of the company must disclose the nature of his interest in the arrangement in the Board meeting.

Whilst the disclosure of information concerning Directors' remuneration is fundamental where ownership and management are separate. Directors inevitably face a conflict of interest when they become involved in determining the pay of persons they are interested. From the accountability and transparency point of view, Section 302 provides that where a company appoints any manager, the Directors of the company have to disclose their interest in such appointment to the members.

### **3. Disclosure Requirement Through Listing Agreements**

Listed companies have to make additional disclosures that are part of the listing agreements between the company and the stock exchange. These are continuous disclosures of major events and happenings in the company.

Information that the management possess is sometimes price sensitive i.e. it will have an effect on the prices and hence a strict disclosure is mandated by the stock exchange. A stock exchange has to operate a fair and transparent capital market. To ensure the optimum functioning of the stock markets and to safeguard the position of investors in those markets, it is extremely important that all investors have access to price-sensitive and other information from listed companies at the same time. These disclosures relate to information on issue of securities, dividends and other issues. Some of the important disclosures mandated in the Stock Exchange listing agreement are as follows:

#### **i) Price sensitive information**

- Clause 19 requires that prior intimation before the Board meeting is to be given to the stock exchange when there is an agenda to decide dividend, bonus and rights issue etc. Intimation to the stock exchange within 15 minutes of the closure of Board meeting on the proceedings of these matters must be given.
- An intimation regarding the payment of dividend, interest and redemption of debentures etc. has to be given to the stock exchange (Clause 21). Intimation within 15 minutes of the conclusion of the Board meeting, particulars about the

changes in the equity capital through bonus shares, rights etc. (Clause 22)

- Company will promptly notify the Exchange action which will result in the redemption, cancellation or retirement in whole or in part of any securities
- Many events may influence the working of the company that will affect the users decision-making process. Such events have to be intimated to the Stock Exchange as per Clause 29 and 30. Changes in the general character or nature of its business. Changes due to resignation, death, removal etc, of the Board and any other key personnel including the Managing Director and the change in the auditors appointed for audit are some of the items that needs to be reported.

### **ii) Documents to be filed with the stock exchange**

Certain documents have to be filed with the stock exchanges, which are covered in Clause 31 and 32 of the listing agreement. These include the copies of the Annual Report, Directors Report and Auditors report along with other documents. Companies also need to report in the annual report the Statement of Cash Flows, Consolidated Financial Statements, Related Party Disclosures, Disclosure of loans /advances and Investments in its own shares or in their subsidiaries, associates etc. Loans and advances in the nature of loans to subsidiaries giving the name and amount must also be reported.

In case the company has changed its name suggesting any new line of business (including software business, then the company will disclose the turnover and income, etc., from such new activities separately in the annual results for a period of 3 years from the date of change in the name of the company.

### **iii) Other information**

- Clause 33 requires intimation of changes in the Memorandum and Articles of Association
- After every annual general meeting the details of the distribution of shareholding and major shareholders has to be filed with the stock exchange The name, number of shares held and percentage shareholding of entities persons holding more than 1 percent of the shares of the company must be given. (Clause 35. )
- Information about certain major events like strikes, lockouts, closure on account of power cut, material litigation and its proceeding, revision in ratings

Any other information having bearing on the operation/performance of the company as well as price sensitive information etc have also to be intimated to the Stock Exchange for public to appraise the position of the company and to avoid the establishment of a false market in its securities. (Clause 36)

- Clause 41 covers the publication of un-audited quarterly results that includes details of segment information in the specified format.

#### **iv) Corporate governance reporting**

In the last three years SEBI has given a number of directives to the stock exchanges to add many items in their listing agreements so that the disclosure regulations are comparable with other countries. One such important addition is the Clause 49, which deals with many issues including corporate governance practices. The governance codes relates to: The number of independent Directors in a corporate Board, procedure for fixing remuneration to the Board, the number of Board meeting and the information required to be given to the Board, the Code of conduct, tenure etc of the Board and the Independent Directors. Matters relating to audit committees and the company's whistle blower policy are also covered in the said clause. Table 2.3 lists the governance requirements. Provisions of Clause 49 requires disclosures to the Board and the various committees and also to the shareholders a statement of Management Discussion and Analysis (MDA) as part of the annual report to the shareholders. MDA information would be helpful in assessing trends and understanding more about the enterprise and management's analysis of financial results. Information given in the MDA are within the limits set by the company's competitive position. Specific items to be included in the MDA are:

- Industry structure and developments.
- Opportunities and Threats.
- Segment wise, product wise performance
- Outlook
- Risks and concerns
- Internal control systems and their adequacy
- Discussion on financial performance with respect to operational performance
- Material developments in Human Resources / Industrial Relations, including number of people employed

Appointment of a new Director or re-appointment of a Director requires disclosures giving a brief resume of the Director; nature of his expertise in specific functional areas and names of companies in which the person also holds the Directorship and the membership of committees of the Board.

The Chief Executive Officer i.e. The Executive Chairman or the Managing Director and the designated Chief Finance Officer (whole-time Finance Director or other person discharging this function) of the company must also give a compliance certificate on the governance related issues.

#### **4. Information Filed with the Registrar of Companies.**

The Companies Act 1956 requires companies to file many documents with the ROC. Any person can inspect these documents unless otherwise specified in the Act (section 610)

These documents relate to:

- The alteration to the memorandum and articles of association,
- Details regarding registration of charges and any modification therein
- Details of share capital and debentures including the increase in the authorised share capital
- Details regarding management and administration. For example, appointment of Directors and auditors
- Copies of the annual accounts and also an annual return needs to be filed with the registrar of companies.

Under Section 234 of the Act, The Registrar of Companies has the power to scrutinise the documents submitted to it and call for additional information and explanation.

#### **5. Disclosure Requirement under SEBI regulations**

One of the objectives of SEBI Act, 1992 is to enhance the level of investor's protection by increasing the transparency and efficiency of the market. SEBI's role in disclosures is limited to issuing directives to the stock exchanges to include certain items under their listing agreements. SEBI directives also cover additional disclosure in the prospectus and other related offer documents. Additional disclosures by companies are also mandated in the case of acquisitions and takeovers.

SEBI has an objective to centralise various information and accelerate its dissemination and by doing so enhance the transparency and efficiency for the benefit of all the stakeholders in the securities market. For this an, Electronic Data Information Filing And Retrieval (EDIFAR) system has been introduced in a phased manner for a select list of such disclosure statements; viz. financial statements comprising of balance sheet, profit and loss account and full version of annual report; half yearly financial statements including cash flow statements and quarterly financial statements, corporate governance reports, shareholding pattern statement and action taken against any company by any regulatory agency.

### **6. Disclosure Requirement in the Accounting Standards**

Section 209 (3A), of the Act requires that the Profit and Loss account and the Balance Sheet of the company must comply with the accounting standards. Accounting standards refers to that recommended by the Institute of Chartered Accountants of India or those prescribed by the Central Government in consultation with the National Advisory Committee on Accounting standards. (Section 210(3C) and Sec.210 A). This provision was introduced by the Companies (Amendment) Act, 1999. Till then, there was no legal backing to the standards. The ICAI has so far issued 29 accounting standards and these are given in Appendix 1 (Panel A). Accounting standards deal with both measurement and reporting.

Under the Act, when the profit and loss account and the balance sheet does not comply with the accounting standards, the companies are required to disclose:

- a) the deviation from the accounting standards
- b) the reason for the deviation and
- c) the financial effect, if any, arising due to deviation.

In a way one could infer that non-compliance of the accounting standards is compensated by disclosure of the financial effects resulting from the deviation.

### **2.6.3 Regulatory Environment**

“Any law that is not enforced is likely to become a mere dead letter”<sup>104</sup>

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<sup>104</sup> J. Dean, *Directing Public Companies* 17 (London: Cavendish Publishing Co, 2001)

While the laws of reporting and accounting are perfected these have to be enforced to be effective. Two of the most important constituents in the disclosure environment are the legal environment and the external auditors.

### **1. Legal Environment**

Legal protection is essential if outside investors are to provide finance to companies. The financial markets need protection of investors, either by court, government agencies or by the market forces themselves from the various moral hazard and information asymmetry problems. Recent empirical studies investigate the effectiveness of different legal environments for investor protection. La Porta et al, relate the quality of investor protection to different legal systems. Legal systems are dichotomised as descending from either the English common law tradition or the Roman civil law tradition. In their study civil law is further classified as countries originating from the French, Germans, or Scandinavians. Constructing an index of legal rules for each of their 49 sample countries, they find that common-law countries grant the best legal protection to investors.<sup>105</sup> The legal environment plays an important role in the disclosure practices of a firm also.

The important functions of the legal system includes legal protection to minority shareholders, voting rights for important corporate matters, ensuring that the owner managers perform their duty to the shareholders, preventing self-dealings and protecting creditors. The extent of corporate legal liability of owners and managers can influence the extent of disclosures the companies make. The legal rules can make companies to be more transparent through the threat of lawsuits. In the US, class action suits by shareholders is very common. For example, if there is a decline in the share price that is also due to any misinformation/ non-communication, shareholders can sue the companies. Companies therefore voluntarily disclose information whether there is profits or otherwise.

Legal system for enforcement of the various laws and standards are also important. A good enforcing authority and legal penalty will ensure that the firms comply with the required accounting regulations. If legal deterrents are absent,

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<sup>105</sup> Supra note 9 at 1131- 1150

then managements have fewer incentives to disclose information. If there is litigation by the investor, the courts must be properly informed to make suitable judgments. The efficiency of the judicial system in a way will also affect the disclosures made.

The legal environment ensures investors confidence through the establishment of market integrity. Market integrity acts as a protective device in the market place where one can do business without being defrauded. A vigilant market regulator will ensure that corporate insiders do not take advantage of the situation to exploit the minority, based on the asymmetry of information. The market integrity presupposes the elimination or a reduction of activities such as insider trading. The role of regulatory institutions hence becomes important for the development and smooth functioning of the capital market. The legal environment includes law and its enforcement. A good legal environment is the key determinant of both financial development and economic growth.

## **2. Audit Environment**

“ The independent public accountant ...owes ultimate allegiance to the company’s creditors and stockholders, as well as to (the) investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client all times and requires complete fidelity to the public trust”<sup>106</sup>

A solution to the agency problem that emerged from the public companies was to get the financial statements to be audited by an independent auditor. To audit the information, the auditors must be able to determine the information presented based on observable outcomes.

The ICAI defines auditing as “a systematic and independent examination of data, statements records, operations and performance (financial or otherwise) of an enterprise for a stated purpose.”<sup>107</sup> The auditing function thus involves evaluating the relevance and reliability of the financial reporting. Auditors provide investors with independent assurance on the financial statement and its conformity with accounting standards. As discussed earlier, since the stock

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<sup>106</sup> Chief Justice Warren Burger in *United States v. Arthur Young and Co.*, U.S. Supreme Court Report 79, 1984, 826-838, as quoted in: D.A. Bavly, *Corporate Governance and Accountability* 161 (London: Quorum Books, 1999)

<sup>107</sup> ICAI, *General Guidelines on Internal Auditing* 5 (New Delhi, ICAI 1984)

prices react to the earnings announcement, one can infer that the financial information is viewed as credible information. The auditors mainly provide the credibility of information.

Section 224 to 233 A of the Companies Act deals with the statutory auditors. At each annual general meeting of the company, the shareholders appoint the auditors who will hold office till the conclusion of the next annual general meeting. The auditors are appointed through an ordinary resolution except where a retiring auditor is not reappointed

The external auditors of a company need to report whether the Balance sheet, Profit and loss account and every other document declared by the Act to be part of the or annexed to the above statements reflect a true and fair view of the "state of company's affairs" as at the end of the financial year. Thus, the main objective of the audit is to conduct an independent review of the financial statements of the company and to give an opinion on them. Section 227 deals with the powers and the duties of the auditors. Statutory audit is valuable to the capital market efficiency as it improves the credibility and reliability of the financial statements. This in turn enhances the effectiveness of the capital markets in allocating the resources and in improving the user's decision making.

Corporate scandals in the recent years involving big companies like Enron, WorldCom Inc and other events related to these companies have raised an important issue of the role of auditors in the financial reporting environment and the auditor's independence. Auditors perceive themselves as hired by the management and hence might act in their interest rather than the interest of the shareholders. This may affect the independent functioning of the auditor.

This dissertation examines the mandatory disclosure relating to reporting and accounting and compares it with the international standards with a view to adopt the best practices. The mandatory disclosures are explored in Chapter 3. The legal environment and enforcement issues and the role of auditors in financial reporting are discussed in Chapter 6.

While there are specific requirements for disclosures in law, all disclosures cannot be specifically mandated. As business practices and business environment constantly change accounting regulations and disclosures must

keep pace with the changes. However, procedural and other problems may delay the pronouncement of accounting regulations. In such cases corporate voluntary disclosures assumes importance and is discussed next.

## **2.7 Voluntary Disclosure Related to Mandatory Disclosures**

While mandatory disclosures are minimum required by the law, companies can give additional disclosures voluntarily but related to the mandatory items. Voluntary disclosures related to mandatory items ensures that the compliance related to the mandatory items are not mere checklist compliance but are made in the spirit of the law. Mandatory disclosures are minimum disclosures required, but the quality and the adequacy of such disclosures are at the discretion of the management. These are usually related to non-financial information disclosure. For example, the Management Discussion and Analysis section requires a company to discuss the future outlook. Since there are no guidelines specifying what needs to be disclosed, companies have discretion to give bare minimum information without actually giving any specific details. Such disclosures are not relevant and does not help in the decision making process. Segment information is another mandatory disclosure. The management has discretion in disclosing segment information. Software companies can call themselves single segment and may not disclose segment information at all. However, certain companies give information relating to the customers or business verticals they service. Thus, voluntarily information disclosed is related to a required disclosure. If companies do not provide additional information the gaps created, are filled by guesses of the investors, which may lead to incorrect decisions making.

## **2.8 Voluntary Disclosures**

Corporate voluntary disclosures have been the focus of researchers in the recent years. Such disclosures can be defined as "disclosures in excess of requirements, representing free choices on the part of the company management to provide accounting and other information deemed relevant to

decision needs of users of their annual report.”<sup>108</sup> Management gives these disclosures voluntarily, which is over and above the mandated requirements. This additional information in a way might reduce the information asymmetry between the market participants.

The financial statements of the company does no contain adequate information for decision making as seen by the difference in the valuation of the shares in the market and the intrinsic value of the shares. In such cases, mandating additional disclosures through the accounting standards or through the auditing assurance, can bridge this information gap to a limited extent only.<sup>109</sup>As the management have an understanding of the business as well as the strategies it has adopted, they can provide additional information to the stakeholders, thereby reducing the information gap voluntarily. Some times such voluntary information is also perceived to be self-serving information.

The factors affecting the voluntary disclosures are discussed in the next section.

### **2.8.1 Factors Influencing Voluntary Disclosures**

When there are mandatory disclosures why should a company disclose information more than the required minimum. Many studies have examined the differences in the levels of disclosures of firms and the various factors that may influence the voluntary disclosures.<sup>110</sup> Differences in disclosure practices will arise as people with varying managerial philosophies manage firms and have wide discretion in disclosing information. Research has identified several reasons to the management’s voluntary disclosures. These can be broadly grouped as the market forces and to an extent industry forces. (See Figure 2.1) Certain other factors also influence voluntary disclosures like the cost of disclosures.

#### **Market forces**

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<sup>108</sup> G.K. Meek, C.B Roberts and S.J. Gray “Factors Influencing Voluntary Annual-Report Disclosures by US, UK and Continental European Multinational Corporations”, 26(3) *Journal of International Business Studies* 555,555-72 (1995)

<sup>109</sup> K.G. Palepu and P. Healy. “The Effect of Firms’ Financial Disclosure Strategies on Stock Prices”, 7(1) *Accounting Horizons* 1-11(1993)

<sup>110</sup> For example see studies by: M. A. Gibbins, Richardson and J. Waterhouse, “The Management of Corporate Financial Disclosure: Opportunism, Ritualism, Politics and Process”,

Competitive market forces may induce the management to disclose more information voluntarily. These forces may act in terms of allocation of capital to companies and in valuation of the company. Firms have incentive to give additional information so that they can raise capital in the best of terms. Companies that need to access the capital market will give more disclosures as they compete for funds.

Firms will give more disclosures so that the market can value them more accurately. Researchers argue that value-generating activities of the firm may not be fully reflected in the financial statements and the investor may not fully understand these. Financial reports do not capture much value relevant information especially of companies in the new economy like the hi-tech and software companies in terms of the intangible assets. Voluntary disclosures by such firms, especially, the non-financial information will help reducing the information asymmetry between the managers and the investors while valuation of these companies.<sup>111</sup>

Studies also focus on disclosure policy and the signaling hypothesis. Signaling theory suggest that management have additional information than the investors. Firms that are under valued have an incentive to disclose more information to signal that fact. The signaling theory is also linked to disclosure practices under asymmetric information assumption.<sup>112</sup> Due to the existence of information asymmetry, direct disclosures will act as a credible signal to the market about the value of the firm.

Firms may also aspire to increase its reputation and therefore would disclose more. In emerging markets the firm's reputational factors are very important. Companies will communicate its good citizenship to its stockholders, and other stakeholders including the governments and societies where it operates. If firms are listed on several and more prestigious exchanges they are likely to disclose more as they are subjected to more pressure from capital

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28 (1) *Journal of Accounting Research* 121-143 (1990), and R. Verrecchia, "Information Quality And Discretionary Disclosure", 5(3) *Journal of Accounting and Economics* 179-194 (1990).

<sup>111</sup> E. Amir and B. Lev. "Value-relevance of Non-Financial Information: The Wireless Communications Industry", 22 (1-3) *Journal of Accounting and Economics* 3-30 (1996) and also R. Kasznik, "Financial Reporting Discretion and Corporate Voluntary Disclosure: Evidence From the Software Industry", *Working paper*, Stanford University (1996)

<sup>112</sup> P. J. Hughes, "Signalling by Direct Disclosures Under Asymmetric Information", 8(2) *Journal of Accounting and Economics* 119-142 (1986)

markets. There is greater investor interest in such firms and usually more information, other than annual report are available to the stakeholders. Listing on a prestigious exchange is a more credible signal of information quality than adopting other accounting standards, in part because such a listing exposes the firm to greater litigation.<sup>113</sup>

At the Micro level, certain firm specific factors may also induce firms to voluntary disclosures. The important determinants of disclosure at the firm level are the size of the firm, the growth curve and the industry they are in. Larger firms will have greater access to different medias and may have large number of analyst following and hence large firms may give more voluntary disclosures than smaller firms. Agency theory suggests that large firms have higher agency costs, which means that these firms should have higher disclosures to mitigate these costs.<sup>114</sup> Large firms in the United States are found to have superior information environments as against small firms.<sup>115</sup> The growth rate of the firm can determine the voluntary disclosure levels.<sup>116</sup> A firm that grows rapidly may give more information.

A firm having poor performance may hide information or offer vague, misleading information during periods of poor performance. Also called as a potential manifestation of the 'cover-up' hypothesis advanced by Murphy and Zimmerman which suggests that managers may exercise discretion in the production and disclosure of accounting information in order to conceal poor performance both by their firms and themselves.<sup>117</sup> Managers will give earnings forecasts when the firms are doing well and this news changes the stock price positively.<sup>118</sup>

Studies on voluntary disclosure indicate that where the company is a subsidiary of a multinational company with audits by a large audit firm, the

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<sup>113</sup> R. Ball, "Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure", *Brookings-Wharton Papers on Financial Services* 127- 83 (R. Litan and R. Herring eds., Washington: Brookings Institution Press, 2001)

<sup>114</sup> R. L. Watts and J.L. Zimmerman, *Positive Accounting Theory* 199 (New Jersey: Prentice – Hall, 1986)

<sup>115</sup> R. Bhushan, "Firm Characteristics and Analyst Following", 11(2) *Journal of Accounting and Economics* 255 -275 (1989)

<sup>116</sup> The growth rate of a firm are often provided by the earnings to price ratio

<sup>117</sup> K. J. Murphy and J.L. Zimmerman, "Financial Performance Surrounding CEO Turnover", 16(3) *Journal of Accounting and Economics* 273-315 (1993)

<sup>118</sup> B. Lev and S. Penman, "Voluntary Forecast Disclosure, Non-Disclosure, and Stock Prices", 28 (1) *Journal of Accounting Research* 49-76 (1990).

disclosures levels will be high.<sup>119</sup> Voluntary disclosures may vary depending on the type of industry and the peer pressure. Certain disclosures are very industry specific. In the pharmaceutical industry, for example, research and development information is more prevalent and sensitive. A company in this industry may disclose more or less information on research depending on the competition sensitiveness.

As countries vary in history, development and cultures they vary in corporate governance structures. Certain pressures from governance structures may induce a firm to disclose more. These may include the auditors, audit committees and the independent Directors. Studies in this area show that having independent Directors is positively associated with comprehensiveness of financial disclosures and the association is weaker for family controlled firms compared to non-family controlled firms. Studies also show that having audit committees would enhance the monitoring of the quality of the financial information.<sup>120</sup> The country-level factors and governance factors taken together provide a lower boundary or minimum level of disclosures within the country. The governance structures vary considerably from country to country; hence the interplay of these various structures may create differences in disclosure levels across countries.

While there are benefits of disclosures, yet firms do not disclose all their relevant information indicating other factors or benefits of non-disclosure. A company that does not wish to suffer the erosion of market capitalisation after announcing a bad news may not disclose adequate information. Management may also want to wait for good news to compensate the bad news. If information is primarily random and good news often cancels out bad news, then choosing not to disclose may avoid or reduce share price changes regarding both types of news.<sup>121</sup>

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<sup>119</sup> K. Ahmed and D. Nicholls, "The Impact of Non-financial Company Characteristics on Mandatory Disclosure Compliance in Developing Countries: The Case of Bangladesh", 29 (1) *International Journal of Accounting* 62-77 (1994) The authors have investigated the factors that influence the level of compliance by companies in Bangladesh

<sup>120</sup> J.P. Chen and B. Jaggi, "Association Between Independent Non-Executive Directors, Family Control and Financial Disclosures in Hong Kong", 19 (4-5) *Journal of Accounting and Public Policy* 285-310 (2000) and also J. J. Forker, "Corporate Governance and Disclosure Quality", 22 (86) *Accounting and Business Research* 111-124 (1992)

<sup>121</sup> For the competitive disadvantage, called proprietary costs see a discussion by Verrecchia for a discussion on these. R. Verrecchia, "Discretionary Disclosure", 5 (1) *Journal of Accounting and*

### Cost of making voluntary disclosures

An important determinant of disclosure is the cost associated with voluntary disclosures. Any additional voluntary disclosures involve cost in terms of money and time. Different types of costs are associated with voluntary disclosures. These costs include 1) costs for preparing additional disclosures 2) litigation costs 3) competitive disadvantage costs and additional constraints on management decision.<sup>122</sup>

In terms of preparation, costs for gathering information, maintaining records and other logistic expenses, additional cost of professional services including accountants and lawyers fees would have to be incurred. Additional managements time would also be spent on scrutiny and discussion of these disclosures.

In countries like US, legal suits against the firms or its managers are very much a threatening reality. In some cases this threat can operate to make more or less disclosures. If information is used by investors for wrong decision-making then the management is liable to be sued. Hence, firms will be cautious in disclosing certain information.

A frequent reason cited against disclosure is the proprietary cost. Proprietary costs are incurred specially when the competitors use the information given by the firm for their own use. Proprietary costs are high in competitive industries. High competition in the product market may act as disincentive for additional disclosures.<sup>123</sup> Information on products sold or status on research while being important to the investor may give information to the competitors. When there are proprietary costs and the information is withheld, the investors may not be able to understand whether the non-disclosure is good news or a bad one. Proprietary cost may influence the type of information, the timing and the details that are provided. To a certain extent they mitigate the adverse selection problem in favour of disclosures.

Political costs also influence the firm's disclosure decisions. These costs

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*Economics*, 179-194 (1983) also D. W. Diamond, "Optional Release of Information by Firms", 40(4) *Journal of Finance*, 1071-1094 (1985) where the author talks of information cost saving framework.

<sup>122</sup> G. Foster, *Financial Statement Analysis* 35 (New Jersey: Prentice Hall Inc, 1986)

are incurred especially when government use information given by firms or by certain industries to levy tax or other duties or withdraw any benefits given.

What ever be the rationale for disclosures the benefits must always exceed the costs. There are not many empirical results on cost benefit analysis of accounting regulation and the methods used to measure cost and benefit.

## **2.8.2 Benefits of Voluntary Disclosures**

Over the years firms have been giving information voluntarily well before they were mandated.<sup>124</sup> One can infer that there are certain benefits accruing to the firms because of these disclosures. Although theoretically disclosures are important and there is a cost benefit trade off involved in the process, empirical evidence on corporate voluntary disclosures is limited to examination of certain benefits only. These benefits mainly take the form of lower cost of capital, low transaction cost, and higher liquidity of firm's shares.

### **Voluntary Disclosures and Cost of Capital**

Research suggests that voluntary disclosures are effective in reducing the cost of capital of a firm.<sup>125</sup> As outlined by Botosan it involves i) reduced information asymmetry between investors and firm management and between investors ii) reduced estimation risk, and iii) increased liquidity. Public disclosure of information such as those conveyed through the accounting reports are important to the liquidity of the capital market. More disclosures result in more liquid markets thereby reducing the cost of capital. More liquid markets are achieved through the reduction of estimation risk, reduction in the transaction cost or by reduction in the information asymmetry.<sup>126</sup>

Voluntary disclosures of public information reduce the information

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<sup>123</sup> Especially, when there is bad news. See for the discussion: R.E. Verrecchia, "Discretionary Disclosure", 5 (1) *Journal of Accounting and Economics* 179, 179-194 (1983).

<sup>124</sup> Benton covers comprehensive evidence on the existence of voluntary disclosures prior to regulatory mandates. G.J. Botosan, "The Effects and Effectiveness of the SEC's Accounting Disclosure Requirements", *Economic Policy and the Regulation of Corporate Securities* 23-79 (H.G. Manne ed., Washington: American Enterprise Institute, 1969)

<sup>125</sup> Botosan and Plumlee studied the association between the expected cost of equity and disclosure ratings of several industries. They found that cost of equity capital and decreases with the higher disclosures in the annual reports and also with the timely disclosures of the quarterly report. C.A. Botosan, and M.A. Plumlee, "A Re-examination of Disclosure Level and the Expected Cost of Equity Capital", 40(1) *Journal of Accounting Research*, 21, 21-40 (2002)

<sup>126</sup> R E Verracchia, "Disclosure and the Cost of Capital: A Discussion", 26 (1-3) *Journal of Accounting and Economics* 271-283(1999),

asymmetry, which can reduce a firm's cost of capital by attracting increased demand from large investors,<sup>127</sup> which means increased transactions. As the transactions go up the liquidity of the markets go up thereby lowering a firm's cost of capital.

The cost of capital is greater for the securities with wider bid-ask spreads, because investors demand compensation for added transaction cost. Therefore, by disclosing information, firms can reduce the adverse selection component of the bid ask spread and reduce their cost of capital.<sup>128</sup> Studies also show that relative bid-ask spreads are negatively related to overall disclosure quality, implying that greater disclosures may reduce the transaction cost and uncertainties.<sup>129</sup>

Greater voluntary disclosures can reduce cost of equity capital by reducing the non-diversifiable estimation risks. Botosan uses a self-constructed disclosure measure to show that greater disclosure is associated with a lower cost of capital. This is measured using accounting earnings for a sample of manufacturing firms. Botosan also suggests that increased disclosures will reduce the estimation risk, which has an effect on the optimal portfolio choice. Disclosure quality and spreads are negatively related. Firms with higher disclosure quality scores exhibit smaller effective spreads, which, means that that high disclosure quality firms reveal smaller information asymmetry spread components. Suggesting that higher quality disclosures are useful in lowering the risk of informed trading.<sup>130</sup> The above studies indicate that higher disclosure will result in more liquid markets thereby lowering the cost of equity capital.

The importance of debt market has made the issue of the disclosures and cost of debts very essential. Rating agencies acknowledge the importance of disclosures while rating the debts of the company in terms of default risk. Many rating agencies such as Standard and Poor's include disclosures as one of

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<sup>127</sup> D. W. Diamond and R. E. Verrecchia, "Disclosure, Liquidity and the Cost of Capital", 46(4) *Journal of Finance* 1325-1360 (1991)

<sup>128</sup> Y. Amihud and M. Mendelson, "Asset Pricing and Bid-Ask Spread", 17(2) *Journal of Financial Economics* 228,223-249 (1986) see also C. A. Botosan, "Disclosure Level and the Cost of Equity Capital", 72 (7) *The Accounting Review* 323-350 (1997)

<sup>129</sup> P. Healy, A. Hutton, and K. Palepu, "Stock performance and Intermediation Changes Surrounding Sustained Increases in Disclosure", 16(3) *Contemporary Accounting Research* 485-520 (1999)

the important items in their rating processes. However, not many studies have been conducted in this area.

When firms make timely and informative disclosures they are perceived to be transparent and hence charged a low risk premium. When firms disclose continuously the cost of capital specially the cost of debt comes down. A Study by Sengupta empirically analysed the cost of debt, and found that firms with high levels of disclosure (from annual reports, quarterly reports, 10 K, press releases and discussions with analysts) had lower costs of debt. Specifically, Sengupta found a 1% increase in his disclosure index to be associated with a 0.02% reduction in the total interest cost of the firm.<sup>131</sup>

### **Other Benefits of Voluntary Disclosures**

Research finds that institutions prefer to invest in firms with superior informational environments.<sup>132</sup> Transient institutional investors that trade aggressively on short-term earning news invest more in firms providing high quality disclosure. Higher disclosures have a positive effect on stock return volatility, arising from the trading activities of the institutional investors.

Firms with more voluntary disclosures have large analysts following, more accurate forecasts for earnings and less dispersion in analysts forecasts for earnings and less variability of forecast revisions.<sup>133</sup> This will reduce the uncertainty and the transaction cost. At the time of initial public issue, greater disclosures will result in decreased issuance cost. The issuance cost or the floatation cost are divided into initial pricing, underwriter discount, administrative expenses and the over allotment option required to make the firm public.<sup>134</sup>

A policy of disclosure makes shareholders better off than no disclosures. When information is disclosed, shareholders need not spend additional resource

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<sup>130</sup> F.H.K. Shaw, and J. Wild, "Disclosure Quality and Market Liquidity", *Working Paper*, [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=251849](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=251849) (March 02, 2002)

<sup>131</sup> P. Sengupta, "Corporate Disclosure Quality and the Cost of Debt", 73 (8) *Accounting Review* 459-474 (1997).

<sup>132</sup> See for example P.Healy, A. Hutton, and K. Palepu "Stock Performance and Intermediation Changes Surrounding Sustained Increases in Disclosure", 16 (3) *Contemporary Accounting Research* 485-520 (1999) also B. Bushee and C. Noe, "Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility", 38(3) *Journal of Accounting Research* 171-202 (2000)

<sup>133</sup> M.Lang and R. Lundholm, "Cross-sectional Determinants of Analysts Ratings of Corporate Disclosures", 31(2) *Journal of Accounting Research* 246-271 (1993)

<sup>134</sup> J.S. Ang and J.C. Brau, "Firm Transparency and the Cost of Going Public", 25(1) *Journal of Financial Research* 1-17 (2002)

in acquiring private information and releasing of additional information by the company reduces the risk element in decision-making. Porter et al studied the effect of disclosures on the shareholders wealth on the American Sugar Industry, which had a policy of not disclosing certain information. Subsequently when they decided to disclose voluntarily, it was found that there was significant favourable shareholder wealth effects.<sup>135</sup>

Studies also show that voluntary disclosure may reduce the trading cost in the international markets. These studies use a rational expectations model to examine how public disclosure requirements affect listing decisions by rent seeking corporate insiders, and allocation decisions by liquidity traders seeking to minimise trading costs.<sup>136</sup> Voluntary disclosures will also enhance the relevance of the financial statements and improve investor relations. Additional voluntary disclosures may help more effective allocation of capital and more liquid capital markets.

This study examines the voluntary disclosure practices of companies through the examination of the company's annual reports. Further, this thesis examines the differences in the levels of disclosures with respect to the ownership structure and other factors. This study also identifies information that would be helpful to the investors, which can be mandated over time or provided as a best practices guide.

#### **2.8.4 Voluntary Self-serving Disclosures**

Voluntary disclosures though said to bridge the information gap has a discretionary element on the part of the managers. Managers' accounting decisions appear sometimes to reflect self-serving behavior, as evidenced by systematic relationships between accounting choices and variables that proxy for management's self-interest.<sup>137</sup> The self-serving behavior may be present in disclosure of voluntary information as well. Managers may select and disclose more or less information depending on their advantage or the benefits they

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<sup>135</sup> B. Porter, K. Sivakumar and G. Waymire, "Disclosure Policies and Shareholder Wealth in the Early Twentieth Century: The Case of the American Sugar Refining Company", 10 (2) *Journal of Accounting, Auditing and Finance* 121-145(1995)

<sup>136</sup> K. G. Palepu, and P. Healy. "The Effect of Firms' Financial Disclosure Strategies on Stock Prices", 7(3) *Accounting Horizons* 1-11 (1993)

derive out of it. As voluntary disclosures are not binding on the management, they may choose to give information that is uninformative and which may not involve additional cost. Some information may also be misleading. Voluntary information is not verifiable and does not impose any penalty for wrong disclosures. These disclosures may or may not be credible.

A study by Lennox, examines whether the chairmen in the failing UK companies make opportunistic or self-serving information disclosures. The study finds a strong evidence that chairmen attempt to cover up poor performance. The study also finds that chairmen are excessively willing to blame poor performance on exogenous factors rather than reveal problems caused by managerial decisions, and 18 out of 38 chairmen do not candidly disclose problems that exist when they write their statements. The study also found that prospective disclosures are more optimistic than disclosures about past performance despite significantly worse performance after the chairman's statements.<sup>138</sup> Although managers blame exogenous factors more often than endogenous factors, their explanations for poor performance may be self-serving. Under the signaling hypothesis prospective disclosures are less favorable than disclosures about past performance. Under the opportunism hypothesis, prospective disclosures are more favorable than disclosures about past performance because management has a greater discretion when discussing future prospects. This in a way is self serving and inconsistent with signaling theory. The self-serving nature of voluntary disclosures thus will lose credibility and the investors will ignore such disclosures.

## 2.9 Chapter summary

To summarise, this chapter looked into the firm's disclosure environment and develop the framework for the study. Disclosures are required by various stakeholders for decision-making and for assessing the state of the financial health of the company. In particular investors need information for making forecasts about the future and to assess the performance and status of the

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<sup>137</sup> P.M. Dechow and R.G. Sloan, "Executive Incentives and the Horizon Problem: An Empirical Investigation", 14 (1) *Journal of Accounting and Economics* 51- 89 (1991)

<sup>138</sup> C. Lennox "Self-serving Disclosures by Chairmen in Failing UK Companies" (2000) <http://ssrn.com/abstract=237968> (Nov 11, 2003)

company. Any information provided must possess the primary quality of relevance and reliability and comparability. Information is relevant when they have predictive and feed back value and is given in a timely manner. Information is reliable when they are verifiable and are free from biases. They must also be the mirror image of the transactions they purport to represent.

The corporate disclosure environment can be categorised into mandatory, voluntary related to mandatory and purely voluntary disclosures.

Mandatory disclosures are minimum required by law and are influenced by various statutes, the cost of reporting and the legal and audit environment of a country. The philosophy of a disclosure-based regulation is to provide the investor with full and fair disclosures in a timely manner for their decision-making. The need for mandatory disclosures arises when there is information asymmetry and when firms do not disclose relevant information. The agency problem also necessitates mandating of disclosures. It is also required from the public interest perspective. The various regulations that govern disclosures in the India are: The Companies Act, 1956, SEBI Act, 1992, the Listing Agreements of the Stock Exchanges and the Accounting standards. An efficient legal and regulatory system and audit are necessary for the smooth functioning of the disclosure environment. Mandatory disclosures relate to both measurement and reporting requirements.

The next set of disclosures is the voluntary disclosures that are given at management's discretion. These may be related to mandatory or purely voluntary. Voluntary disclosures of firms are affected by many factors like the competitive forces and the industry forces. Companies benefit from voluntary disclosures through reduced information asymmetry, reduced estimation risk and increased liquidity leading to reduction in cost of capital. Whatever be the nature of disclosure they must be of acceptable standards.

Disclosures of accounting and reporting must be of certain standards. Standards are recognised as examples of excellence in any field. These standards can relate to both measurement and reporting and be comparable with international standards. Reporting and accounting standards followed in India and disclosure practices are discussed in the subsequent chapters.

**Table 2.1: List of Standards Relating to Reporting**

AS 1	Disclosure of Accounting Policies	AS 20	Earnings per share
AS 3	Cash Flow Statements	AS 21	Consolidated Financial statements
AS 4	Contingencies and Events occurring after the balance sheet date	AS23	Accounting for investment in associates in consolidated financial statements
AS 5	Net Profit or loss for the period, prior period items and changes in accounting policies	AS 24	Discontinuing operations
AS 17	Segment Reporting	AS 25	Interim Financial Reporting
AS 18	Related party disclosures	AS 27	Financial Reporting of Investments in Joint venture

**Table 2.2: List of Standards Related to Measurement and Accounting**

AS 2	Valuation of Inventories	AS 13	Accounting for Investments
AS 6	Depreciation Accounting	AS 14	Accounting for Amalgamations
AS 7	Accounting for construction Contracts	AS15	Accounting for retirement benefits in the financial statements of the employers
AS 8	Accounting for Research and Development	AS 16	Borrowing Costs
AS 9	Revenue Recognition	AS 19	Leases
AS 10	Accounting for Fixed Assets	AS 22	Accounting for taxes on income
AS11	Accounting for effects of changes in foreign exchange rates	AS 26	Intangible Assets
AS 12	Accounting for Government Grants	AS 28	Impairment of Assets
		AS 29	Provisions, Contingent Liabilities and Contingent Assets

**Table 2.3: Items to be Included In The  
Annual Report of Companies (Annexure 1B of Listing Agreement)**

1. A brief statement on company's philosophy on code of governance.
2. Board of Directors: <ul style="list-style-type: none"> <li>• Composition and category of Directors</li> <li>• Attendance of each Director at the Board meetings and the last AGM.</li> <li>• Details about other Board/ Committee membership</li> <li>• Number of Board meetings held, dates on which held.</li> </ul>
3. Audit Committee. <ul style="list-style-type: none"> <li>• Brief description of terms of reference</li> <li>• Composition, name of members and Chairperson</li> <li>• Meetings and attendance during the year</li> </ul>
4. Remuneration Committee. <ul style="list-style-type: none"> <li>• Brief description of terms of reference</li> <li>• Composition, name , attendance during the year</li> <li>• Remuneration policy</li> <li>• Details of remuneration to all the Directors, as per format in main report.</li> </ul>
5. Shareholders Committee. <ul style="list-style-type: none"> <li>• Name of non-executive Director heading the committee</li> <li>• Name and designation of compliance officer</li> <li>• Number of shareholders' complaints received so far</li> <li>• Number Complaints and pending complaints</li> </ul>
6. General Body meetings. <ul style="list-style-type: none"> <li>• Location and time, where last three Annual General Meetings(AGM) held.</li> <li>• Whether any special resolutions passed in the previous 3 AGMs</li> <li>• Details of special resolution through postal ballot and voting pattern</li> <li>• Person who conducted the postal ballot exercise</li> </ul>
7. Disclosures. <ul style="list-style-type: none"> <li>• Disclosures on materially significant related party transactions</li> <li>• Variation from the Accounting standards with explanation.</li> <li>• Details of non-compliance by the company, penalties imposed on the company by any authority on matter related to capital markets, during the last three years.</li> <li>• Whistle Blower policy and access to the audit committee.</li> </ul>
8. Means of communication. <ul style="list-style-type: none"> <li>• Half-yearly and Quarterly results</li> <li>• Newspapers wherein results normally published</li> <li>• Any website, where displayed and also displays official news releases</li> <li>• The presentations made to institutional investors or to the analysts.</li> <li>• Whether Management Discussion and Analysis is a part of annual report.</li> </ul>
9. <b>General Shareholder information</b> <ul style="list-style-type: none"> <li>• AGM : Date, time and venue and Financial Calendar</li> <li>• Date of Book closure and Dividend Payment Date</li> <li>• Listing on Stock Exchanges and Stock Code</li> <li>• Market Price Data : High., Low during each month in last financial year</li> <li>• Performance in comparison to indices such as BSE Sensex etc</li> <li>• Registrar and Transfer Agents and Share Transfer System</li> <li>• Distribution of shareholding</li> <li>• Dematerialisation of shares and liquidity</li> <li>• Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity</li> <li>• Plant Locations and Address for correspondence</li> </ul>