Chapter I

INTRODUCTION

1.1 Financial Disclosures and Corporate Governance

The last two decades have seen a surge in research on corporate governance. Increasing interest in corporate governance has been attributed to increased competition for capital due to deregulation and integration of world capital markets (Yoshikawa & Phan, 2001). Several other reasons have also been identified for the growing interest in the issue of corporate governance. These include increased privatization the world over, the takeover spate of the 1980s, the East Asia crisis, and the series of recent corporate scandals across the globe (Becht, Bolton, & Rosell, 2002). Corporate governance systems have thus evolved in response to corporate failures or systemic crises.

The East Asian crisis has been responsible for giving a fillip to corporate governance in developing economies of Asia. The crisis which had its bane in inadequate financial disclosure and lack of corporate transparency drove home the importance of good corporate governance. The crisis placed pressure on Asian companies to improve transparency, fortify external monitoring and increase investor protection (Nowland, 2008). One of the most important lessons learnt from the crisis is that poor corporate governance creates liability for both, individual companies and society as a whole.

Poor corporate governance and resultant accounting scandals have raised numerous concerns about the quality of financial reporting and disclosure (Brown, Falaschetti, & Orlando, 2010). The link between corporate governance and financial disclosures has been extensively debated in developed economies. There exists extensive research on the subject in US using US data. Given that different business practices, different institutional environments and culture impact corporate governance, there is an urgent need for workable corporate governance model for Asia. It is only recently that focus has shifted to the study of corporate governance and financial disclosures in emerging markets. In India, emphasis on corporate governance disclosure studies has seen a revival. Several studies have examined corporate governance in India generally.
However, a comprehensive study on existing level of corporate governance is of enormous practical importance and a key to safeguard larger interests of the stakeholders. Lack of a governance framework that permits detailed analysis of transactions taking place between various components of a corporation like employees, owners, suppliers, customers, management and society can harm the long term interests of all the stakeholders concerned.

This study extends and contributes to the body of existing research by using Indian data to examine the existing level of corporate governance disclosures. It investigates the likely impact of firm related attributes on corporate governance disclosures. The study links differences between level of firms’ corporate governance disclosures and some of the individual, observable firm characteristics.

1.1.1 Genesis and Evolution of the Corporate Governance Issue

The word “governance” traces its root to the Latin term “gubernare” which means – “to steer”. Corporate governance is as old as the origin of corporations because the rise of corporates also gave rise to governance issues. The term corporate governance does appear relatively new but the issues it addresses have been around for much longer, since Berle & Means (1932). The origin of corporate governance can be traced to the ‘Agency Theory’ which is over two centuries old. Agency relationships occur when one partner in a transaction (the principal) delegates authority to another (the agent) and the welfare of the principal is affected by the choices of the agent (Adam Smith, 1776).

Berle & Means (1932) in their seminal work 'The Modern Corporation and Private Property' posit that in a modern corporation, there is a separation of ownership and control where ownership lies in the hands of the shareholders and control lies in the hands of the manager stewarding the company. The owner needs the managers’ specialised human capital to generate returns on his funds. The manager needs the owners’ funds since he does not have enough capital of his own or does not want to take risk with his own funds. Thus, in an organisation, the relationship between shareholders and managers is a classic example of the principal – agent problem. The agency theory states that when there is separation between ownership and control of
corporations, there is potential for conflict of interest between owners and management. This theory assumes that managers are opportunistic. The goals of the managers are not aligned with the goals of the shareholders. Hence their self-serving behaviour needs to be controlled by directors or vigilant shareholders. The principal's problem is to motivate the agent to act in a manner that will achieve the principal's goals. The principal can limit the impact of divergence of interests by incurring monitoring costs to curb the agent’s self-serving behaviour. The essence of corporate governance is about how owners (principals) of firms can ensure that the firm’s assets (and the returns generated by those assets) are used efficiently and in their best interests by managers (agents) delegated with powers to operate those assets. This concern is valid for any arrangement where owners themselves do not undertake the management functions directly.

The blanket assumption of self-aggrandizing behavior of managers is one of the biggest criticisms of agency theory. It does not take into account how different institutional and cultural environments impact human behaviour. Also, its depiction of human behaviour as self-serving is rather pessimistic.

The traditional view of the firm has been that of a product function where capital and managerial efforts are factors of production. These factors of production are deployed by the functionaries in the firm to the best of their understanding. However, the neo-classical theory views the firm as a nexus of contracts. The contracts are between the various resource owners i.e. shareholders and managers. The resource owners come together, through the firm, to increase productivity. Based on this view, the numerous shareholders who provide capital to the company are its actual owners. The shareholders elect a Board of Directors to monitor the running of the company on their behalf. The Board of Directors appoints a team of functionaries who actually handle the execution of day to day transactions of the company. This team of functionaries regularly reports back to the Board of Directors.

The conflict of interest between the management and shareholders is the seminal cause of the corporate governance issue. In large and complex organisations, the shareholders, through the Board of Directors oversee the performance of the
management in whose hands the stewardship of the firm lies. There is no single, one
fit, utopian system of good governance. Each company, based on its culture and
priorities has to arrive at a governance paradigm that maximises shareholder value in
the long term.

Corporate governance models, as they exist today, can be classified into two types –
market based and bank based. The market based model is the American or British
model which is based on outside control and widespread ownership. Shareholder's
rights are secure and financial markets play a key role in the corporate governance
process. Financial markets reward efficient performance with a rise in share price,
thus lowering the firm's cost of capital. Market of corporate control in the form of
takeovers protects against errant managers. Thus, financial markets protect the interest
of the shareholder. In the bank based system prevalent in Japan and Germany, there
exists a universal bank which has a say in the functioning of the company. The bank
owns shares in the company and also has board representation. The bank thus plays an
important role as provider of finance and regulating day to day functioning of the
company. Despite their differences, both these models operate in a similar external
environment, one which is well regulated.

India’s corporate governance model is a hybrid of the arms-length market based
systems of U.K and U.S.A and the insider-dominated bank based systems of Germany
and France (Sarkar & Sarkar, 1999). Though the basic structure of the firm is similar
to the one in the US model, ownership is less dispersed. Replacing banks of the bank
based system it is the financial institutions (FIs) which play a pivotal role as providers
of capital. Institutional ownership and representation on the board empowers these
FI’s to monitor day to day activities of management. However, FI's are less powerful
than the banks of the bank based system.

With increased focus on corporate governance across the world, the Indian regulatory
system has also geared up. The year 1991 was the year of liberalisation of the Indian
economy and integration with the world economies. Globalisation brought with it a
culture of investor protection. The most important step to increase investor protection
was setting up of Securities Exchange Board of India (SEBI) in 1992. SEBI was
responsible in framing the threshold rules of corporate conduct in India. Investor well being and protection was at the core of SEBI's ideology. It had to balance between imposing restrictions and relaxing them. SEBI was set up with the multi pronged agenda of monitoring transactions in the capital market, protecting investors and improving transparency in trading of securities. Specifically, the institution of Clause 49 of the Listing Agreement rendered a formal beginning to the process.

The year 2009 was yet another turning point in the study of corporate governance. The year saw the debacle of Satyam Computer Services, a leading Indian outsourcing firm that had a third of Fortune 500 companies as its clients. The debacle was largely attributed to financial bungling and misrepresentation. Operating margin of Satyam was a fraction of what it declared. Corporate collapse and related frauds of this nature have raised doubts about the credibility of the operating and financial disclosure practices of listed companies in India. Weakness of corporate governance has been named the most critical element in this regard. Failures and criticism of prevalent corporate governance practices served as catalysts for legislative and regulatory change. This experience brought together a number of professional and regulatory organizations such as Reserve Bank of India (RBI), The Institute of Chartered Accountants of India (ICAI) and SEBI to recommend reforms for improving the system of corporate governance. At this juncture, India can ill afford the consequences of a weak corporate governance mechanism. The Companies Bill (2009) and Corporate Governance Voluntary Guidelines (2009) have been instituted by the Ministry of Corporate Affairs as a next step towards providing directions to Indian companies as regards good corporate conduct.

1.1.2 Financial Disclosures

There has been considerable debate about the need for strong corporate governance structures (Bujaki & McConomy, 2002). Search for mechanisms to ensure good corporate governance focus on reliable and high quality financial disclosures. Financial disclosures are the communication of economic data arising out of a firm's transactions to its multiple stakeholders. Disclosures should be true, fair, relevant and material as they serve the purpose of presenting the transactions undertaken by the
firms. There is no scope for any ambiguity or miscommunication regarding the firm's operational efficiency. Audited balance sheets, income statements, cash flow statements, along with other disclosures, form the basis of information available not only to investors and regulators, but also creditors, employees and public at large.

Disclosures play a facilitating function. They aid the decision making process of persons to whom they are addressed. The information disclosed depends on legal provisions incorporated in the ‘listing agreement’ and ‘disclosure standards’ as laid down by professional bodies. Adequate disclosure leads to good governance. Despite extensive research on the subject, there still exists considerable ambiguity over the topic of good governance. Even in developed world economies, there is disagreement about how good or bad the existing governance mechanisms of firms are. Corporate governance literature in developed economies has evolved especially since the corporate accounting scandals of 2001-2002. Corporate governance mechanisms in evolved countries like US, UK, Japan, and Germany have achieved fair degree of success. Main drivers of effective corporate governance mechanisms in these countries are:

- Transparency in terms of disclosure of relevant financial and operational information and internal processes of management oversight and control.
- Protection and enforceability of the rights and prerogatives of all shareholders.
- Directors being capable of independently approving the corporation’s strategy and major business plans and decisions, and of independently hiring management, monitoring management’s performance and integrity, and replacing management when necessary.

All the above stated characteristics are there to achieve the broad objective of good corporate governance which is maximizing long term shareholder value (Ahmed, 2006). While there are several other critical elements besides financial disclosure in a corporate governance system, such as role of independent non-executive directors, role of auditors, top management compensation, the present study focuses only on one element of corporate governance - the role of adequate financial disclosure. Financial
reporting and disclosure is an important component of a corporate governance system since it allows investors and other outside parties to monitor firm performance and contractual commitments. Globalization necessitates that governance mechanisms in emerging markets be augmented. Improved corporate governance systems can serve as an incentive for foreign investment. Some improvements suggested to solve the corporate governance problem may be codes of conduct, whistle blower policies, rating agencies to focus on substance over form and penalties for financial indiscipline.

All the above stated alternatives rely on information presented in the financial statements. Inadequate financial disclosures would hinder the implementation of any solutions posited above. It is the quality of corporate financial reports of a firm that determines the quality of its corporate governance. Financial reporting and disclosure is an important component of corporate governance since it allows all stakeholders of the firm to monitor firm performance (Bushman & Smith, 2001). They argued that a fundamental objective of corporate governance research in accounting is that the information provided in financial accounting systems should mitigate agency problems. Research in the field of corporate governance disclosure during the recent years has mainly focused on the disclosure practices found in the annual reports. Transparency in corporate financial disclosure inculcates discipline in management and enables appropriate valuation of the company. Thus financial reports propel management to act efficiently in the best interest of the owners/shareholders. Financial reports are the basis on which management is accountable to the Board of Directors and the Board of Directors to the shareholders.
Figure 1.1 depicts the actors in the governance process, highlights their interactions and establishes the role of financial disclosure as the starting point in the corporate governance mosaic.

![Figure 1.1: Actors in the corporate governance process](chart)

**Figure 1.1** Actors in the corporate governance process


From the structure presented in figure 1.1, financial disclosure forms the base of the corporate governance edifice. Management is internally controlled by Board of Directors and internal auditors. External players in this mosaic comprise of external auditors, regulatory authorities and the capital markets. The interactions of all these players are based on financial disclosures. Accurate and extensive disclosure is thus fundamental to the governance process.

In order to address the issue of corporate governance disclosure, OECD principles of corporate governance, Cadbury Committee recommendations for European companies and Sarbanes-Oxley legislation in the US are some of the well known norms that emerged. OECD (1999) endorsed a set of principles, standards and guidelines fostering corporate governance at an international level. This set of guidelines (revised in 2004) is considered to be the basic framework of corporate
governance discipline. The principles are built on core standards which are fairness, transparency, accountability and responsibility.

- **Fairness:** The corporate governance framework should protect shareholders' rights. It should ensure balanced treatment of all shareholders, including minority and foreign shareholders. All shareholders should have opportunity to obtain effective compensation for violation of their rights. This principle recognizes that shareholders are owners of the corporation and as owners they have the right to pursue their interest in the corporation.

- **Transparency:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the corporation. This principle recognises that investors and shareholders need information about the performance of the corporation. This information should be prepared in accordance with high quality standards of accounting and should be subject to annual audit.

- **Accountability:** The corporate governance framework should ensure strategic guidance of the corporation, effective monitoring of management by the board, and the board's accountability to the corporation and the shareholders. This principle obligates the directors to avoid self interest and act diligently on a fully informed basis.

- **Responsibility:** The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. This principle recognizes that corporates must adhere to the legal infrastructure within which they operate.

A number of attempts have been made by various researchers throughout the world to understand the ‘determinants of corporate governance disclosures’. There are three main determinants of corporate governance disclosure quality (Klapper & Love, 2004). These are the utility of corporate governance for the firm, the nature of firm’s
operations and firm’s size. The potential determinants of firm level corporate governance disclosure quality indicate that companies with greater growth opportunities, greater needs for external financing, and more concentrated cash flow rights tend to practice higher quality governance and disclose more (Durnev & Kim, 2005). In Italian financial market, governance features are affected by shareholders’ composition, balance sheet and company performance data, and some qualitative features (Barucci & Falini, 2005). Empirical examination of determinants of adoption of corporate governance practices in Canada shows that a firm’s need or desire to access capital markets in the future becomes a prime determinant for firms implementing governance mechanisms (Anand, Milne, & Purda, 2006).

1.1.3 Voluntary vs. Mandatory Disclosures

The basic goal of both voluntary and mandatory mechanisms is to emphasize disclosure. Difference between voluntary and mandatory disclosures is only of degree, mandatory disclosures being higher as they are driven by significant monitoring and/or enforcement. A company’s disclosure has elements of voluntary choice and involuntary compliance (Gibbins, Richardson, & Waterhouse, 1992). The key element which leads to different corporate governance patterns across countries is the varying degree of legal protection offered to investors across countries (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Some countries like UK and Germany prefer a “comply or explain” system of corporate governance disclosure while others e.g. Brazil rely on firms to voluntarily adopt best practices. This leads to varied degrees of motivation to adopt better corporate governance practices amongst firms.

With globalisation and the ensuing accelerated pace of reforms, developing countries are left with no choice but to enhance disclosure. Given the preponderance of family ownership coupled with poor protection of minority shareholders’ rights, and high costs of monitoring the behaviour of corporate insiders, governments in developing countries have a key role to play. The extent of use of public means of corporate governance enforcement is a concern that governments and policy makers need to address. The choice is not between voluntary and mandatory disclosure. It is between
a rules based regulatory system of enforcement and a well developed judicial system and the challenge is to make both mechanisms work.

1.2 Corporate Governance - The Indian Perspective

It has often been debated whether existing theories of corporate governance which were developed within the context of developed economies could be generalised to Asian economies, particularly, India and China. A theory should be generic to different observations across countries (Cheng, 1994). The institutional environment in India characterised by family and government ownership, weak legal investor protection and lack of active market for corporate control creates unique challenges for corporate governance. The Indian financial sector is characterised by a relatively underdeveloped equity market plagued with manipulation and rudimentary analyst activity. These features make corporate governance a particularly important issue in India. There is a need for entirely new set of theories given the unique Indian landscape.

As Indian firms such as ICICI Bank, Infosys and WIPRO enter global markets, they have increasingly started interacting with regulators and investors from the developed world. Pressures from multilateral agencies on global markets for adequate disclosure are rising. Asian companies that want to tap international capital markets will have to put their house in order as regards disclosure requirements (Tripathi, 1998). According to a McKinsey Emerging Market Investor Opinion Survey (2001), financial disclosure scored a rating of 4.4 on a five point scale which measured its perceived importance by current and proposed investors. This implies financial disclosure was regarded highly important as financial statements serve as a perfect platform to judge managerial decision making.

Governance requires maximisation of shareholder's value which is enabled by transparency and accurate disclosure. A company's corporate governance policies are reflected in the practices of its board of directors, their relationship with its top managers and the checks and balances that exist to ensure management's honesty, fairness and transparency. A poll conducted by KPMG on ‘The State of Corporate Governance in India: 2008’ between November 2008 and January 2009 involving 90
respondents including chief executive officers and chief financial officers of private equity, financial services and manufacturing sector brought out that 35 per cent of the respondents considered weak reporting and monitoring as the biggest risk to corporate governance in India. On the quality of disclosures made under the Management Discussion and Analysis (MDA) part of the annual report, 88 per cent of the respondents rated the quality of these disclosures as moderate or low. (The MDA highlights structure, developments, opportunities, threats, and concerns of the company).

1.3 Central Issues in Corporate Governance and Financial Disclosure in India

The history of corporate governance in India is not very old. Until 1991, India pursued socialist policies. The state owned developmental financial institutions were the main providers of long term credit to companies. With respect to corporate governance, this system resembled the German Bank based model where these institutions could have played a key role in keeping their clients on track. However, the performance of the government owned providers of capital was measured by the amount of capital invested rather than return on investment. Also, the directors of the financial institutions served on the boards of the companies they lent to. The borrower therefore had little reason to either service the loan or run their business effectively. A weak judicial system and delayed bankruptcy proceedings provided the perfect setting for borrowers to default. Standards of corporate governance began to deteriorate.

The number of registered companies has increased many times over since 1956. The Indian corporate sector plays a significant role in creating wealth for the nation. The accompanying task is to manage this vast sector. The current legal framework surrounding corporate governance in India primarily comprises of the Companies Act-1956. The Ministry of Corporate Affairs (MCA) has the sole responsibility for compliance with Companies Act. By exercising supervision over three professional bodies namely, Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India (ICSI) and the Institute of Cost and Works Accountants of India (ICWAI), the MCA directly monitors functioning of the corporate sector in the country.
1.3.1 Changes since Liberalisation of 1991

It was in 1991 that the Indian government faced a fiscal deficit. The crisis led to a series of reforms aimed at opening up the hitherto protected economy. Some reforms were reduction in state aided financing and privatization in the banking sector. Pressed by a need to face increasing competition, Indian firms began to tap world capital markets for equity. This growing interface with world markets led to efforts aimed at augmenting corporate governance standards. The pioneer endeavours in this area were setting up of the CII Code for Desirable Corporate Governance in 1998. SEBI constituted two committees to focus on the issue of corporate governance. The committee chaired by Kumar Mangalam Birla, chairman of the Aditya Birla group, submitted its report in the year 1999 and the committee chaired by Narayan Murthy, founder and chief mentor of Infosys, submitted its report in 2003. These committees played an instrumental role in laying the foundations of corporate governance in India. They have had maximum impact on changing the corporate governance complexion in India. The recommendations of these committees brought to light the fact that governance reforms are focussed on two major areas - disclosure laws and role and composition of Board of Directors.

1.3.2 Current Framework of Corporate Governance in India

The following section outlines the legal and regulatory framework of corporate governance in India. The Ministry of Corporate Affairs, Securities and Exchange Board of India, Reserve Bank of India and Institute of Chartered Accountants of India (ICAI) play a major role in defining this framework.
a. **Legal Framework**: The legal framework of corporate governance in India is defined by the Companies Act of 1956 which has been recently amended, and Clause 49 of SEBI’s requirements for listed companies. The Ministry of Corporate Affairs, through The Companies Act of 1956 has been working towards strengthening of the corporate governance framework. The Companies Act is the single most important legislation regarding corporate India. It encompasses most functional aspects of public limited companies. The recommendations of various committees on corporate governance have also aimed at reforming this Act to incorporate specific governance provisions related to independent directors and audit committees. The New Companies Bill is a huge overhaul of Company Law. It fixes more responsibility on independent directors, focuses on self regulation and calls for adequate disclosure.

Major corporate governance reforms have been orchestrated through Clause 49 of the Listing Agreement. A listing agreement is between a company and the stock exchanges on which it is listed. Prior to adoption of Clause 49, India corporate governance mechanisms were not at par with world standards. Clause 49 brought in a number of key changes in governance and disclosures in all listed companies. An amendment to the Clause 49 in 2003 made it mandatory for every public company listed on Indian stock exchange to sign the listing agreement. Clause 49 was further revised in 2004 and came into effect in the year 2006. The main focus of the revised clause has been to protect the interests of investors through enhanced governance
practices and disclosures. The key features of Clause 49 regulations deal with composition of the board of directors, composition and functioning of audit committee, governance and disclosures regarding subsidiary companies, chief executive officer / chief financial officer certification and reporting on corporate governance as part of annual report. It is now mandatory for the Indian listed companies to file with SEBI, the corporate governance compliance report, shareholding pattern along with the financial statements. Clause 49 requires that listed companies disclose materially significant related – party transactions in the report on corporate governance.

Clause 49 is modelled on the basis of the Sarbanes Oxley Act of 2002 which was introduced by the Securities Exchange Council (SEC) for companies listed in the US Stock Exchanges. Clause 49 makes top management responsible for all financial statements and internal procedures of the company which is also the crux of the Sarbanes Oxley Act (SOA). India measures up with SOA with regard to prohibition of insider trading, prohibition of insider loans to directors, real time disclosure of changes in financial or operating information of companies, auditors prohibited from offering certain kinds of non- audit services.

However, the main difference between the Sarbanes Oxley legislation and Clause 49 is the power to prosecute. While SOA mandates up to twenty years of imprisonment in case of fraud or destruction of records, no such provision exists under the Clause 49. The severest penalty for non compliance with Clause 49 is the de – listing of a security. The authority to pursue criminal action lies with the Ministry of Corporate Affairs which has the ultimate responsibility to supervise compliance with the Companies Act of 1956.

Clause 49, India's answer to SOA of US is clearly a defining point in the evolution of corporate governance practices in India. While SOA generated a negative investor reaction in US, Indian investors exhibited a contrasting positive reaction to introduction of Clause 49. The different reaction of Indian investors is on account of expectation of a positive impact of Clause 49 on improving the corporate governance scenario in the country.
Listed Indian companies must by law follow fairly strict standards of governance and disclosure. Regulators have put into place some of the best international practices, including good quarterly reporting standards and timely availability of information. However, in order to attain global best practices, India will have to improve governance standards through voluntary compliance and self-regulation. India can flaunt a robust legal mechanism, but it is the spirit of the law which is more important than the letter.

**Regulatory Framework:** SEBI is the capital markets regulator in India. It works towards protection of investor rights through disclosure requirements, accounting standards and establishment of small investor's protection group. Though SEBI was primarily established to regulate and monitor stock trading, it gradually promulgated many corporate governance regulations and guidelines. It has since then been active in bringing out many regulations to improve the corporate governance standards in India. The two committees constituted by the SEBI - Kumar Mangalam Birla and Narayana Murthy committee were important steps towards improving corporate governance in India.

Rather than taking a regulatory approach as that prescribed by the Sarbanes-Oxley Act of US, Asian countries have chosen to implement voluntary corporate governance codes of conduct. These codes advise companies how to improve their governance and disclosure practices. The codes while not mandatory, do encourage companies to implement stronger corporate governance structures and release more information in a timely manner to market participants (Sareen, 2009).

Details of the Indian committees on corporate governance are as follows:

**Confederation of Indian Industries Code (1998)**

The CII constituted a National Task Force under the chairmanship of Rahul Bajaj, for the study and recommendation of the code of corporate governance for the Indian corporate sector. On the basis of suggestions presented by the committee in 1998, a Desirable Corporate Governance Code was framed. Three aspects were considered crucial by the committee. Firstly, there is no specific corporate governance structure
in the developed world nor is one type of structure superior to others. Secondly, Indian companies cannot afford to ignore better corporate governance practices. Lastly, corporate governance goes beyond company law. This committee made 17 recommendations on different subjects of corporate governance. These include the quantity, quality and frequency of financial and managerial disclosure, the extent to which board of directors exercise their responsibilities towards shareholders, quality of information that management shares with their boards and the commitment to run transparent companies that maximize long term shareholder value.

**Kumar Mangalam Birla Committee report (1999)**

SEBI constituted a committee under the chairmanship of Kumar Mangalam Birla to understand the matters of corporate governance and recommend necessary suggestions. The committee was to view corporate governance from the perspective of investors and shareholders and to prepare a code to suit the Indian corporate environment. The committee identified three major constituents i.e. shareholders, board of directors and management and three key aspects of corporate governance i.e. accountability, transparency and equal treatment for all stakeholders. The committee made twenty-five recommendations and categorized them as mandatory and non-mandatory.

**Naresh Chandra Committee report (2002)**

In 2002, a committee was instituted under the chairmanship of Naresh Chandra. The committee was to analyze and recommend changes in diverse areas such as auditor and company relationship, change of statutory audit firm, procedure of appointment and determination of auditor fees, independence of auditing firms, measures to ensure presentation of fair and true statements, necessity of having a transparent system, adequacy of regulation of different statutory functionaries and the role of independent directors. Encompassing these broad objectives, committee suggested thirty recommendations in four chapters.
In order to review the existing code on corporate governance, SEBI formed yet another committee under the chairmanship of N.R. Narayan Murthy, including representative from the stock exchanges, chambers of commerce, investor associations and professionals' bodies. This committee reviewed the performance of corporate governance in order to increase the transparency and integrity of market.

The recommendations of these committees related to disclosure and transparency have been given in table 1.1 that follows.

**Table 1.1 Recommendations on Disclosure and Transparency**

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<td>(a) Companies should inform their shareholders about the high and low monthly averages of their share prices and about share, performance and prospects of major business segments (exceeding 10% of turnover).</td>
<td>(a) Companies should provide consolidated accounts for subsidiaries where they have majority shareholding.</td>
<td>(a) Management should explain and justify any deviation from accounting standards in financial statements</td>
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<td>(b) Consolidation of group accounts optional and subject to FI’s and IT department’s assessment norms. If a company consolidates, no need to annex subsidiary accounts but the definition of “group” should include parent and subsidiaries.</td>
<td>(b) Disclosure list pertaining to “related party” transactions provided by committee till ICAI norms are established.</td>
<td>(b) Companies should move towards a regime of unqualified financial statements.</td>
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<td>(c) Stock Exchanges should require compliance certificate from CEOs and CFOs on company accounts.</td>
<td>(c) A mandatory Management Discussion &amp; Analysis segment of annual report that includes discussion of industry structure and development, opportunities, threats, outlook, risks etc. as well as financial and operational performance and managerial developments in HR / IR.</td>
<td>(c) Management should provide a clear description, followed by auditor’s comments, of each material contingent liability and its risks.</td>
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<td>(d) For companies with paid-up capital exceeding Rs. 20 crore, disclosure norms for domestic issues should be same as those for GDR issues.</td>
<td>(d) Management should inform board of all potential conflict of interest situations.</td>
<td>(d) CEO/CFO certification of knowledge, veracity and comprehensiveness of financial statements and directors’ reports and affirmation of maintaining proper internal control as well as appropriate disclosure to auditors.</td>
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<td>(e) On (re)appointment of directors, shareholders must be informed of their resume, expertise, and names of companies where they are directors.</td>
<td>(e) Security analysts must disclose the relationship of their employers with the client company as well as their actual or intended shareholding in the client company.</td>
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*Source: Corporate Governance in India – Evolution and Challenges, R. Chakrabarti (2005).*
The Ministry of Corporate Affairs has sought to provide policy direction to Indian companies on issues of responsibility and accountability by issuing a Voluntary Code of Corporate Governance in December 2009. The Code guides companies in a manner which makes businesses ethical, transparent and accountable to its shareholders. It aims to bring in business gains through increased disclosures.

**Voluntary Code of Corporate Governance Guidelines 2009**

It broadly deals with

- **Appointment of Directors** – appointments to the board, separation of offices of chairman and chief executive officer, nomination committee, number of companies in which individual might become director.

- **Independent Directors** – attributes of independent directors, tenure of independent directors, independent directors to have the option and freedom to meet company management periodically.

- **Remuneration of directors** – guiding principles linking corporate and individual performance, remuneration of non-executive directors (NEDs), structure of compensation to NEDs, remuneration of independent directors (IDs), remuneration committee.

- **Responsibilities of the Board** – training of directors, enabling quality decision making, evaluation of performance of board of directors, committees thereof and of individual directors, board to place systems to ensure compliance with laws.

- **Audit Committee** – constitution, enabling powers, roles and responsibilities.

- **Auditors** – appointment, rotation, certificate of independence, need for clarity on information to be sought by auditor and/or provided by the company to him/it.

- **Secretarial Audit**

- **Whistle Blowing Mechanisms**
The establishment of the voluntary code mentioned above is a deviation from the mandatory requirements set out by Clause 49 of the listing agreement. This code expects companies to voluntarily adopt best practices and thus follows an approach different from the Sarbanes Oxley Act of US.

**c. Accounting Standards Framework:**

The Institute of Chartered Accountants of India (ICAI) plays a pivotal role in laying down Accounting Practices and Standards for Indian corporates to follow. Although corporate accounting principles are moving towards harmonised international accounting practices and disclosure is improving, certain gaps still need to be filled in. Indian Accounting Standards though differ from IFRS (International Financial Reporting Standards) in many ways are inspired by the US GAAP.

The ICAI introduced a concept paper recommending a full switch to IFRS for Indian companies by April 2011. Although the corporate sector in India is a mix of government and private firms, it has not suffered from the inefficiencies that dominated some of the developing economies in East Asia. Accounting system in India is well established and is similar to those followed in most of the development economies.

**1.4 Statement of the Problem**

The study attempts to understand an integral element of corporate governance i.e. financial disclosure in the context of the Indian environment. This line of research helps to understand what can lead companies to improve their governance practices as regards financial disclosure. The main objective of this research is to study the existing corporate governance disclosure levels of listed Indian firms, both large and medium, from the year 2002 to 2009. Another objective is to investigate the determinants of firm-level corporate governance disclosure among listed Indian companies, aiming to identify firm characteristics associated with high corporate governance disclosures.
The study specifically deals with the following issues:

- What is the level of corporate governance disclosures in listed Indian companies?
- What firm level attributes determine corporate governance disclosure of listed Indian companies?
- Have firms in India improved their disclosure standards over time?
- How to augment corporate governance disclosure in Indian listed companies?

1.5 Overview of the Research

The importance of financial disclosures is driven by the fact that they are an important source of communication between the principal and agent. The study, by addressing itself to understanding disclosure levels of Indian companies, is expected to provide useful insights into reducing information asymmetry between principal and agent. There is a large variation in the quality of corporate governance practices adopted by firms that are subject to the same contractual environment. Therefore, it is possible that firms within the same country have widely divergent standards of overall corporate governance. This implies that different Indian firms could have varying standards of corporate governance disclosure. This study aims to link varying standards of corporate governance disclosures to observable firm characteristics.

In conducting this research, annual reports have been used as a main source of information. Annual reports of the companies should be considered as the most important source of information about a company (Karim & Ahmed, 2005). The amount of disclosure made in companies’ annual reports beyond the amount required by regulations is a good proxy for the overall voluntary disclosures made by a firm through all modes available to it (Botosan, 1997). Therefore, data for disclosure were collected from company annual reports.

A fundamental objective of corporate governance research in disclosure is to provide evidence of the extent to which information provided in financial accounting systems mitigate agency problems (Bushman & Smith, 2001). Research in the field of corporate governance disclosures during recent years has mainly focused on the
disclosure practices in the annual reports of the firms. A number of attempts have also been made by various researchers across the world to establish determinants of corporate governance.

This study uses a disclosure instrument adapted from the Standard and Poors’ (S&P) Disclosure Survey to measure transparency and disclosure of Indian firms using eighty eight attributes. The sample consists of 114 companies selected on the basis of random sampling. The sample has been divided into large sized companies and medium sized companies on the basis of net worth. The sample has also been divided into eight industry sectors in order to analyse the difference in corporate governance disclosures among diverse sectors.

Statistical tests examine the difference in disclosure practices of firms based on firm characteristics namely size, proxied by market capitalisation, profits, leverage, revenues in foreign exchange, listing status, and belonging to financial/ non- financial sector, public/ private sector. Results of the study show that corporate governance disclosure is significantly influenced (at 5 per cent level) by size of the company (represented by market capitalisation) and whether the company is internationally listed or not. The multiple regression model output also brings out that in India, profitability, leverage, foreign exchange revenues, whether the company belongs to financial or non- financial sector, public or private sector are not significant contributors towards ensuring better corporate governance.

1.6 Organisation of the Research Study

The study is divided into five chapters. Relevant prior literature on financial disclosure and corporate governance has been reviewed in Chapter II. Corporate governance literature has been divided into two parts – studies conducted in India and studies conducted outside India. Review of literature brings to light external and internal disciplining mechanisms that aid corporate governance. Disclosure of financial information facilitates both external and internal disciplining mechanisms. Past studies have also revealed factors impacting corporate governance disclosure. Based on the review of extant literature done in Chapter II, research gaps have been identified, research questions formulated and objectives have been laid down in
Chapter III. Fifteen testable hypotheses have been formulated in this chapter. The model used to test the hypotheses and the definitions of variables have been stated. Statistical tools used to test the hypotheses have been discussed. Sample selection and data collection techniques have then been reported. Chapter IV begins with specifying the characteristics of the sample in terms of mean and standard deviation. Further, the frequency distributions of disclosure scores of the sample are presented. A sector wise frequency distribution of disclosure scores is also presented. A component wise break up of disclosure score for large and medium companies has also been provided. The fifteen hypotheses developed in chapter three have been tested in this chapter. It is found that hypotheses related to firm size and listing status have been supported. Also, hypotheses related to difference in level of corporate governance disclosures of large and medium companies belonging to services and manufacturing sector have been supported. Finally, Chapter V concludes the study and provides suggestions and directions for future research. The appendix has been placed at the end.