INTRODUCTION
CHAPTER I

INTRODUCTION

Accounting is often called the language of business. The American Accounting Association defines accounting as “the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information” [ASOBAT (1996), p.1]. The acceleration of change in our society has contributed to increasing complexities in this language, which is used in recording, summarizing, reporting and interpreting basic economic data for individuals, businesses, governments and other entities [Fess and Warren (1984)]. With the advent of modern technology and industrial development, the importance of maintenance of accounts came into being and gradually gained momentum. In view of the complexity in the industrial structure, accounting system took a new shape owing to its demands for the presentation of information of the business transactions on a more scientific and sophisticated manoeuvre which are proved to be convenient and feasible to the interested groups [Himachalam and Kumar (1995)].

The ultimate output of accounting is in the form of corporate financial reports, which communicate essential information to users, thus helping them to take a variety of decisions. These reports can be meant for internal users, viz., management or external users viz., shareholders, debenture holders, financial institution, security analysts, government, creditors, suppliers and general public. External reporting of information
has assumed great significance over a period of time because of increase in the size of business units, scarcity of funds to finance the increased scale of operations, emergence of a large number of small investors, separation of ownership and management, increased public awareness, recognition by managements of their responsibility toward various stakeholders and increased regulation of government forcing the companies to publicly make available essential business information.

Till 1900, corporate secrecy dominated the minds of corporate managers and as a result, the quantum of corporate disclosure was very small. This was because (i) there was no tradition of publicity, for no one could have thought of asking individual proprietors, partners or early family owners to divulge such information, (ii) managers feared that by revealing financial information they would unwittingly assist their competitors and (iv) to many the doctrine of caveat emptor seemed as applicable to buyers of securities as to purchasers of horses [Hawkins (1986)]. Ownership and management if not with the same persons, were closely related and the owners were in continual personal touch with the affairs of the enterprise. As there were few or no outside investors there was little need for the management to think about, the need of financial disclosure.

The focus of corporate reporting shifted to stewardship reporting in the early 20th century. With the growth of the company form of organization and with the separation of ownership and management resulting therefrom, the stewardship function of management assumed greater importance. This view point considers management as the steward
to whom capital suppliers, e.g., shareholders and creditors, entrust control over a portion of their financial resources [Beaver (1989)]. So the objective of financial statements was to report to suppliers of capital on the control and use of their resources thus reflecting the accountability of management towards them.

In the late 1960s, the perspective shifted to an informational approach. According to this approach, the basic purpose of financial statements is to provide information useful to various users, viz., investors, creditors, management, government, security analysts, consumers and the general public. This shift in emphasis is fully reflected in the objectives of financial statements developed by the Financial Accounting Standards Board (FASB). According to the Trueblood Study Group Report, "the basic objective of financial statements is to provide information useful for making economic decisions." [Sorter and Gans (1974) p.5]. SFAC 1 (1978) states that "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." This statement evidently stresses the absolute need of transparency in the presentation of financial statements, that is to say, profit and loss account and balance sheet should embody all the information having economic implications, which otherwise gravely affects the end users, without holding back or suppression of any vital information [Himachalam and Kumar (1995)]. The transparency in accounting goes a long way in reposing the confidence of the users regarding the operating and financial position of the business.
1.1 SIGNIFICANCE OF DISCLOSURE

Corporate disclosure or reporting signifies a total communication system between the corporation and its interested constituents. Information about a company's affairs can be communicated through different media, viz., prospectus, financial press releases, annual report, interim reports and personal contacts with company officials. However, the published corporate annual report is undoubtedly the most widely distributed comprehensive source of corporate financial data [Stone(1967)].

(Full disclosure of information by a company assumes a great deal of significance for investors, the company and the nation as a whole.)

Financial information can affect the distribution of wealth among investors [Beaver(1989)]. Differential access to information may permit the more informed investors to increase their wealth at the expense of the less informed. Public disclosure of information by a company will remove this information asymmetry.

Financial information can also affect how investment is allocated among investors [Beaver (1989)]. Disclosure may alter investors' beliefs about relative risks and rewards associated with particular securities and will help them in selecting the best portfolio of their investments.

Investors will prefer to invest in a company that discloses fully rather than in a company that does not. In a free competitive market, such investor actions will increase the stock prices of the company making greater amount of disclosure. And an upward move in stock prices will reduce the cost of capital of the company [Chandra (1984)]. The Special
Committee on Financial Reporting of the American Institute of Certified Public Accountants (1994) also known as Jenkins Committee states that an important benefit of greater disclosure is lower cost of equity capital. The study conducted by Botosan (1997) provides direct evidence of an association between disclosure level and cost of equity capital. Theoretical research supporting a negative association between disclosure level and cost of equity capital has followed two related thrusts. The first is that greater disclosure enhances stock market liquidity thereby reducing cost of equity capital through reduced transaction costs or increased demand for a firm's securities. This stream of research includes Demsetz (1968), Copeland and Galai (1983), Glosten and Milgrom (1985), Amihud and Mendelson (1986) and Diamond and Verrecchia (1991). The second stream of research which includes Klein and Bawa (1976), Barry and Brown (1985), Coles and Cowenstein (1988), Handa and Linn (1993), Coles et.al. (1995), and Clarkson et. al. (1996) suggests that greater disclosure reduces estimation risk arising from investors' estimates of the parameters of an asset's return or pay off distribution.

Financial information can affect the rate of capital formation in an economy, resulting in reallocation of society's wealth between consumption and investment [Beaver (1989)].

Full disclosure of financial information tends to lessen the fluctuations in the securities market. An empirical study conducted by Singhvi and Desai (1971) shows that inadequate corporate disclosure in annual reports is likely to widen fluctuations in the market price of
securities, since investment decisions in the absence of adequate information are based on less objective measures.

Thus full disclosure of information helps the present and potential investors in taking informed decisions regarding the selection of the best portfolios of their investments; reduces the cost of capital of the company; affects the reallocation of society's wealth between consumption and investment; and reduces the fluctuations in the securities market.

1.2 EMERGING CAPITAL MARKETS AND CORPORATE DISCLOSURE

The 1990s can be regarded as the decade when certain exotic or remote financial markets, more popularly known as Emerging Capital Markets (ECMs) captured the interest of investors worldwide with their promise of offering substantially higher returns compared to the more developed financial markets (Hilton 1994; Price 1994). An emerging capital market is understood to mean a stock market located in a developing country. Despite their potential for significantly higher gains, investments in ECMs are also prone to greater volatility. The risk of investing in ECMs are not associated with only structural, political or economic problems, although admittedly these factors are important (Claessens et.al. 1995; Harney 1995). Equally important are informational problems stemming from the difficulty of obtaining adequate and reliable information useful for evaluating investment opportunities in these markets [Saudagar and Diga (1997)]. Before ECMs can fulfill their developmental roles, it is essential to have in place a set of corporate reporting policies and procedures geared toward supplying the
information necessary for making investment decisions. This view has been supported by international lending institutions like World Bank and Asian Development Bank (ADB). In its report on capital market developments in the Asia-Pacific regions, the ADB (1995) stressed that "accounting information is an essential element of infrastructure for a financial system." The World Bank (1989-90), in turn observed that "in developing countries, accounting and auditing practices are sometimes weak and financial laws and regulations do not demand accurate and timely reports. Developing an effective accounting and auditing profession is essential for building efficient financial markets." The worldwide pre-eminence of US and UK capital markets has been associated in part with the stringent nature of financial reporting in these countries, which, in turn resulted in the increased availability of information for decision making purposes [Saudagaran and Diga (1997)]. As pointed out by Walter (1993), the nature and extent of information production and disclosure is central to equity market development and the ability to attract cross-border flows. The stronger and more independent the information infrastructure, the more attractive an emerging market will be to foreign equity investors. Available evidence suggests that information disclosure levels are quite low in ECMs as compared to the developed markets. A recent study that compared financial disclosure of industrial enterprises from 41 developed and emerging stock markets showed that enterprises in ECMs generally provided less disclosures compared to those in developed markets (CIFAR 1995).
At present there are 47 countries whose capital markets are considered ECMs by the International Finance Corporation [IFC (1995)], the World Bank’s Investment Arm. India is one amongst these 47 countries. In this context the issue of corporate disclosure has assumed a great deal of significance in India.

1.3 CORPORATE REPORTING ENVIRONMENT IN INDIA

Countries differ with regard to their corporate reporting practices because of various legal, economic, social, cultural and political factors. Choi and Muller (1986) have identified several environmental factors that have a direct impact on the development of accounting in any country. These include legal system, political system, nature of business ownership, differences in the size and the complexity of business firms, social climate, level of sophistication of business management and of financial community, degree of legislative interference in business, presence of specific accounting regulation, speed of business innovations, stage of economic development, growth pattern of economy and status of professional education and organisation. Nobes (1992) has specified legal systems, business organization and ownership, stock exchanges, taxation and the profession to be some important causes of international differences among financial reporting systems. According to Zarzeski (1996), information disclosure, denoting how open a society is, relates to the degree of secretiveness of a country’s culture. The results of his study show that enterprises from more secretive countries disclose less investor oriented information and vice versa, enterprises from more individualistic and more masculine countries disclose more information and enterprises from countries exhibiting less uncertainty disclose more information.
Financial reporting practices in India, reflect to a great extent the influence of many of these factors.

Previous colonial links strongly influence the choice of an accounting regulatory system. ECMs often share similar financial reporting legislation and practices with the countries by which they were formerly colonized [Saudagar and Diga (1997)]. India has faced a long phase of about two centuries of British colonisation. It has also left its imprints on the Indian accounting and financial reporting requirements. The British Companies Act was used as a model while framing the Indian Companies Act.

Unlike in the United States, the securities markets and securities legislation in India have not had a dominant influence on accounting and reporting requirements [Narayanaswamy (1996)]. The Companies Act, 1956 contains comprehensive accounting requirements for all the companies. Until recently, the stock exchanges and securities regulators have generally limited themselves to laying down the requirements for disclosure of non-accounting information by listed companies. However, recently it seems to take active interest in the area of financial reporting.

Nature of business ownership also significantly influences the disclosure of information. Widespread public ownership of corporate securities would lead to greater disclosure of information to the public, while large shareholdings by groups e.g., financial institutions, families etc. would seem to limit sharing of financial information with the members of the owning groups. In India, extensive cross-holdings of shares and interlocking of directorships by the members of families are
fairly common because of concentration of economic wealth among a few well-positioned groups in society. Further, financial institutions own a sizeable number of shares in many companies. However, with the advent of liberalisation, the share of public ownership of companies is likely to increase and this may lead to improved financial disclosure.

The social climate in India has also influenced the level of corporate disclosure. In sharp contrast to the countries like the USA the social climate in India is highly conservative and therefore demands considerably less financial disclosure [Narayanaswamy (1996)]. But this climate is now changing. Rising consumerism and social awareness are likely to lead to a demand for increased disclosure of corporate information.

The relatively low speed of business innovations has also influenced the reporting practices [Narayanaswamy (1996)]. For example, business combinations resulting in mergers or acquisitions have become popular in India only in the last few years. Equipment leasing is still in its infancy in terms of the volume of business, types of assets covered and varieties of products. The level of sophistication of financial instruments is very low by international standards. Since there are not many business transactions requiring complex accounting treatments, measurement and disclosure practices have remained fairly simple.

It is clear from the above discussion that till now the financial reporting environment in India didn’t provide any incentive to the corporate sector to incorporate the advances in the area of corporate disclosure internationally. The Indian companies believe in the “less said, the better” policy when it comes to disclosing their operations [Sridhar and Ganesh (1996)].
This fact has been supported by various research studies conducted by different researchers from time to time. Singhvi (1967) who compared the corporate disclosure levels in India and the USA concludes that the disclosure of information in annual reports by the listed companies in India is less adequate and less investor oriented as compared to the listed companies in the USA. Most of the Indian companies disclose in their annual reports the information guided by the legal requirements and such information falls short of what is desired by the investors. Shankar (1974) conducted a study to examine the adequacy of disclosure in the Indian annual reports as compared to the annual reports of the USA, Germany, Britain and Japan. He concludes that the balance sheet of Indian companies is the least innovative, informative, and is prepared largely within the legal framework. The foreign annual reports are much informative and illustrative. Gupta (1977) also points out the insufficient disclosure requirements for the Indian companies vis-a-vis companies of other countries, viz., the USA, Australia, the UK, France and Japan. Marston (1986) concludes that the overall corporate disclosure is greater in the United Kingdom as compared to that of India.

It is evident from the above that till now, the Indian corporate disclosure practices have been very restrictive in nature. But all this is changing. The 'globalisation wave initiated by the Government of India in 1991 has put an impact on every aspect of business activity. Accounting and financial reporting is no exception to this. With the integration of world trading markets, financial markets are also showing signs of dependence and integration. The geographical barriers have vanished. Companies are desperate to tap any corner of the world to raise funds at the lowest possible cost. Many Indian companies have also started
approaching overseas capital markets to raise funds. Portfolio investment by foreign institutional investors is now allowed. Many Indian companies are dreading to enter what is inarguably the world's largest equity and debt market, i.e., the US market, but has exceptionally tight financial reporting standards [Sridhar and Ganesh (1996)].

The advent of globalisation and liberalisation is likely to influence the corporate disclosure levels of the Indian companies. It has been argued that the degree of internationalisation of the economy is a determinant of the quality of financial reporting. According to Radebaugh and Gray (1993), as the degree of internationalisation of the economy increases, financial reporting systems tend to move towards internationally accepted benchmarks. In order to raise funds from global market, it is essential that the disclosure practices must also be raised to global standards. Indian companies have also started realizing the importance of expanded corporate disclosure levels in the current scenario. The initiative has been taken by the Infosys Technologies Limited (a leading Indian software company with extensive international operations), which has recently provided supplementary unaudited US GAAP financial statements in addition to the financial statements required under the Indian Company Law. According to V. Balakrishnan Manager (Finance) of Infosys, this is a step towards fulfilling the vision of the company to become a "Globally Competitive Software Company." Following US GAAP would ensure that the financial statements of the company are on par with the best in the world. On similar lines, Reliance Industries Ltd. (RIL) has hired the services of one of the big six accounting firms to help it in the process of preparing annual reports based on the requirements of the
SEC of the USA, so that RIL could get itself registered at one of the US stock exchanges.

1.4 ABOUT THE STUDY

The study makes an attempt to comprehend and the compare the level of disclosure made by the US corporate giants vis-a-vis the top Indian companies for the year 1994-95. The US disclosure practices have been selected as a benchmark for the Indian corporate sector to improve its disclosure practices. This selection has been made keeping in mind that the US generally accepted accounting principles typify the toughest and the best investor friendly disclosures in the world. They insist from the companies such financial data which can radically alter an investor's perceptions about a company [Sridhar and Ganesh (1996)]. The disclosure norms under the US GAAP are highly restrictive in nature. The regulatory agency of the US, the Securities and Exchange Commission (SEC) is considered to be the strongest and the most influential and the dominance of the US in the standard setting at international level is also evident [Nobes (1991)].

The fact, that the US disclosure practices are the best has also been supported by the studies conducted by different researchers from time to time. The study conducted by Barret, (1976) is the most comprehensive in this regard. He analysed the corporate disclosure practices prevalent in seven countries, viz., the United States of America, Japan, the United Kingdom, France, Germany, Sweden and Netherlands. The study concludes that the corporate disclosure has been found to be more comprehensive in case of the American and the British firms. Another study conducted by Benston (1978), which compares the corporate
disclosure in the UK and the USA, concludes that corporate disclosure is far more extensive and detailed in the USA than in the UK. The study of seven industrialized countries i.e., France, Germany, Hongkong, Japan, Norway, the UK and the US, conducted by Zarzeski (1996) concludes that the US has the highest number of customary disclosures, while France has the lowest. According to him, the US has a capital market/ investor orientation, while France has a government orientation.

It is evident from the above that the US corporate disclosure practices have been considered to be the best for the last several decades. It is also strongly perceived that the US disclosure practices are bound to dominate the international corporate scenario in future. The selection of the US corporate disclosure practices as a benchmark will provide an opportunity to know the areas in which disclosure practices of the Indian corporates are lagging behind and need improvement.

Secondly, the study also attempts to capture the improvements in the disclosure levels of the Indian corporate sector following the liberalisation policy of the Government of India. Corporate disclosure levels of the sample Indian companies have been compared at two points of time, i.e., the year 1990-91 and 1994-95.

The study also attempts to compare the timeliness of the Indian and the US corporate annual reports.

Finally, an attempt has also been made to study the influence, of certain corporate attributes viz, size, profitability, age, nature of industry and auditing firm on the corporate disclosure levels and timelines of corporate annual reports.
1.5 **OBJECTIVES OF THE STUDY**

The objectives of the study are:

1. To measure and compare the current status of disclosure levels of the Indian and the US companies.
2. To comprehend changes in the disclosure levels of the Indian companies following the liberalised economic policies of the government (from the year 1990-91 to the year 1994-95).
3. To study the influence of certain corporate attributes, viz; size, profitability, age, nature of industry and auditing firm on the disclosure levels of the Indian as well as the US companies.
4. To study the timeliness of the Indian and the US corporate annual reports and to study the relationship between the reporting time lag and selected corporate attributes.

1.6 **RESEARCH METHODOLOGY**

Chapter 4 titled 'Research Methodology' provides details regarding the research methodology applied in this study.

1.7 **LIMITATIONS OF THE STUDY**

The following are the limitations of this study:

1. This study attempts to generalize the disclosure practices of the US and the Indian companies on the basis of the sample size of 100 companies each. It is possible that some of the generalisations undergo a change if the sample size is increased substantially beyond 100.
2. The results of the study are based on the responses received from the US and the Indian companies [respective response rates being
30 percent; 41 percent (1990-91)] and 60 percent (1994-95). A higher response rate might have put an impact on the conclusions derived from the analysis.

3. This study uses a disclosure index in order to facilitate the process of evaluation of annual reports. To prepare a disclosure index, two approaches could be used. One based on the weights assigned on the basis of relative importance of information items. The other based on the premise that all items in the index are of equal importance and hence carry equal relative weights. This study depends on the latter school of thought and uses an unweighted disclosure index.

4. The disclosure index is composed of list of 212 information items. Though every care has been exercised to make the list an exhaustive one, it is possible that some items do not figure in the disclosure index.

5. One of the objectives of the study is to establish a relationship between the nature of industry and the disclosure score. While carrying out a cross-sectional analysis of the companies, two limitations surface. Firstly, the industry grouping for the US companies is not comparable with the grouping made for the Indian companies. Secondly, the number of companies in some industry groupings is too small to be representative of that industry.

1.8 ORGANISATION OF THE STUDY

This study has been organised into eight chapters. Chapter I discusses the introductory part of the study. Chapter II throws light on five major issues confronting the corporate disclosure practices.
Chapter III focuses on the regulatory framework of corporate disclosure in India and the US.

Chapter IV provides details regarding the research methodology applied in this study.

Chapter V comprehends and compares the disclosure practices of the Indian companies during the pre-liberalization and post-liberalization periods e.g., 1990-91 and 1994-95. It also comprehends the disclosure practices of the US companies for the year 1994-95. Then a cross-national comparison of the current status of corporate disclosure practices in the two countries has been made.

Chapter VI is concerned with the impact of certain corporate attributes on the disclosure levels and discusses the results of simple linear regression and step-wise regression applied to study the same.

Chapter VII comprehends and compares the current status of timeliness of the Indian and the US annual reports on the one hand and establishes a relationship between certain corporate attributes and reporting lag on the other.

Chapter VIII presents a summary of the study.