CHAPTER 3

HYPOTHESIS DEVELOPMENT

As identified from literature review, the focus of the current research was to examine the extent of disclosures made by Indian firms and the impact of corporate governance mechanisms on the extent of discretionary disclosures. As indicated in the prior section, some of the prior studies have examined the relationship between certain attributes of governance with the discretionary disclosures. However, this study proposes to examine the overall impact of the major corporate governance mechanisms operating in a firm. Hence the study required the identification of the constructs that would indicate the various corporate governance mechanisms in a firm.

The four major corporate governance mechanisms examined in the current study are ownership structure, board characteristics, board functioning and audit committee characteristics. The framework linking corporate governance and disclosure is based on the positive agency theory (Jensen and Meckling 1976). Theoretically, the impact of internal governance mechanisms on corporate disclosures may be complementary or substitutive (Ho and Wong 2001). Greater disclosures by the firm are expected if a complementary effect exists and lower disclosures are expected if a substitutive effect prevails. As no conclusive evidence exists, the relationships predicted in the study are mainly positive, based on the ‘complementary’ effect (Ho and Wong 2001).
3.1 CONSTRUCTS OF THE STUDY

Disclosure – This construct includes the discretionary disclosures made by a firm in the annual report. It includes the seven sub-indices of disclosure, measured from the annual report of the firm. The index for measurement of disclosure was based on a detailed review of literature with appropriate tests to ensure the reliability and validity of the instrument and the scoring procedure. The process is explained in detail in Section 4.3.

Ownership Structure – This construct represents the proportion of shares held by various categories of shareholders and indicates the concentration in the ownership structure of the firm as a corporate governance mechanism.

Board Characteristics – The board is the most important corporate governance mechanism of a firm due its ability to monitor the various activities of the firm. The basic characteristics of the board such as the number of members of the board, the role of the chairman of the board and the effectiveness of the members of the board are an important corporate governance mechanism of the firm.

Board Functioning – Apart from the basic characteristics of the board, the effectiveness of board functioning indicates the rigour of enforcement of corporate governance mechanisms. This construct represents the effectiveness of board processes.

Audit Committee Characteristics – The audit committee is one of the most important committees of the board and is held responsible for the effectiveness of the reporting process. The committee is therefore a vital
mechanism in the framework of corporate governance. The characteristics of
the audit committee and the effectiveness of its functioning are indicated
through this construct.

Firm Characteristics – The basic characteristics of the firm such
as the size of the firm, age, profitability, leverage and growth of the firm play
a significant role in all activities of the firm. Additionally, as prior research
has indicated that firm characteristics influence the nature of corporate
governance activities of the firm, it has been included in the study as an
indicator of the unmeasured aspects of governance of the firm.

3.2 RESEARCH HYPOTHESES

3.2.1 Increase in Discretionary Disclosures

As presented in the earlier sections, there have been numerous
corporate governance issues and reporting frauds that have shaken up investor
confidence in the capital markets. Significant financial misrepresentations
impact not only the financial statements of a firm but also have an impact on
the narrative disclosures of the firm resulting in omission of material matters
in some sections of the annual report (Crawford and Weirich 2011). To
counteract this, regulatory authorities have been framing rules and regulations
to ensure adequate disclosure of corporate activities. Also, a number of
proactive firms are looking worldwide and taking a lead role in disclosing
material beyond the mandatory requirements. As the years go by, these
disclosure elements are expected to gradually go up as a norm. This leads us
to the hypothesis

H1 : The extent of discretionary disclosures has increased over the
    last five years
As the study explores the disclosure practices in seven categories, the following hypothesis relating to the sub-indices are formulated.

\[ HI_a \] : The extent of board related disclosures has increased over the last five years

\[ HI_b \] : The extent of business environment related disclosures has increased over the last five years

\[ HI_c \] : The extent of financial disclosures has increased over the last five years

\[ HI_d \] : The extent of general disclosures has increased over the last five years

\[ HI_e \] : The extent of human resource related disclosures has increased over the last five years

\[ HI_f \] : The extent of social and governance disclosures has increased over the last five years

\[ HI_g \] : The extent of strategic disclosures has increased over the last five years

### 3.2.2 Dimensions of Corporate Governance

Prior researchers have employed various approaches to measure the corporate governance of a firm. The most common measure of governance has been the use of published governance index (Klapper and Love 2004; Durnev and Kim 2005, Aggarwal et al 2010, Bruno and Claessens 2010). The widely used indices were those published by agencies such as Standard & Poor's, Credit Lyonnais Securities Asia and Institutional Shareholder Services. However, the availability of such published indices is limited to few countries. The indices are also limited to a subset of firms within the country
and are not published every year. Due to the non-availability of appropriate corporate governance data some researchers have used questionnaires constructed specifically for the study (Durnev and Kim, 2005; Gompers et al 2003; Balasubramanian et al 2010; Bebchuk et al 2005). Several studies have used modified versions of these questionnaires, adapted according to requirements of the country and objective of the study. But, the low response rate of some studies using this method has led to the use of firm-level data available from secondary sources as indicators of corporate governance. This study measures corporate governance by using some of the firm-level indicators identified in prior research (Ho and Wong 2001; Eng and Mak 2003). The following sections indicate the development of hypothesis based on such firm-level measures

3.2.3 Ownership Structure and Discretionary Disclosures

The ownership structure of a firm determines the extent of control that providers of funds can impose on the management of the firm (Jensen 1993, Shleifer and Vishny 1997). Ownership structure determines the extent of convergence of interests and extent of monitoring possible by providers of funds. Several facets of ownership have been used in various studies as indicators of corporate governance. The most common measures used are, proportion of shares held by classes of shareholders such as individuals, managers, members of the board of directors, institutions, family or business group. These groups have been found to be imperative to the mosaic of corporate governance as they hold substantial block of shares that bestow upon them the rights to control the firm (Morck et al 1988).

Ownership structure has been examined as an indicator of the degree of effectiveness of the internal governance mechanisms based on two
contrasting hypothesis, the expropriation hypothesis and the monitoring hypothesis (Shleifer and Vishny 1986). The expropriation hypothesis expects agency conflict between large shareholders or the controlling owners and the minority shareholders leading to expropriation by the controlling group (Khanna and Palepu 1998). But, the monitoring hypothesis expects that concentrated ownership or consolidation of voting power among many shareholders may put pressure on the firm for good governance practices. The unpretentious assumption, based on agency theory (Dalton et al 1999) expects that greater overlap between ownership and control would reduce agency conflicts thereby resulting in higher firm value. Concentrated ownership through the ‘disciplining’ role has been found to avert the traditional free rider problem (Grossman and Hart 1980) that arises due to dispersed shareholding (Shleifer and Vishny 1986).

In India, ownership in many firms is concentrated with promoters of the firms and it was found that the average shareholding by promoters in Indian firms was 34 percent (Kaur and Gill 2009). The promoter, according to SEBI, is a person/s in overall control of the company, or who has been instrumental in the formulation of a plan or program pursuant to which the securities are offered to the public, or those named in the prospectus as promoters. The definition does not include any person employed in the firm in a professional capacity. Although promoters may not hold majority of shares of a firm, pyramiding and cross-holding structures enable them to retain control of the firm (Khanna and Palepu 2000). These have led to disparity between the ownership rights vis-à-vis the control rights possessed by the promoter group.

In such circumstances, it is expected that management would be in the hands of promoters and voluntary disclosures would be low. Prior
research has found that the demand for disclosure is relatively low in a concentrated structure than in a diffused ownership environment (Chau and Gray 2002). Hence it would be expected that firms with relatively high levels of concentrated promoter ownership, would have lower levels of transparency and relatively lower discretionary disclosures (Jensen and Meckling 1976; Chau and Gray 2002). Moreover, as the promoter group would enjoy some private benefits, it would desire such activities to remain unobservable to the other shareholders. It is therefore likely that the controlling group would seek to reduce the extent of disclosures beyond the mandatory requirements.

However, in countries with low regulatory governance mechanisms, it is expected that concentrated shareholding acts as substitute for good governance and hence results in positive effects. In such circumstances, it is likely that there would be greater disclosures.

Concentration of shares could also lie with the institutional investors of a firm as they invest in large chunks of shares. In the Indian context, institutional ownership refers to the shares of a firm owned by domestic institutions such as financial institutions, insurance companies, Central and State governments, venture capital funds and foreign institutional investors.

The active investor hypotheses (Sundaramurthy et al 2005) posits that institutional investors have the ability to proactively monitor managerial actions due to their ability to ‘voice’ their opinion rather than just exit the firm. A majority of institutional shareholding is in large blocks which allow them to monitor and discipline the management of the firm (Monks and Minnow 1995; Chibber and Majumdar 1999, Khanna and Palepu 2000, Sarkar and Sarkar 2000, Verma 2007). Moreover, as large institutional investors
have greater benefits it acts as an incentive for monitoring (Shleifer and Vishny 1986).

Research examining governance, institutional ownership and disclosure has identified two contradictory effects of institutional ownership. The ‘myopic’ view posits that, institutional investors are more interested in short-term earnings and hence force invested firms to adopt a myopic view in choosing investment projects or other major decisions, constraining corporate disclosures in lieu of private gains (Jiang and Habib 2009). The contradictory view posits that institutional investors, due their large shareholding force management to make long-term, value-maximizing decisions that help in improving the governance mechanisms of the firm and resultant corporate disclosures. However, many recent studies do not support the ‘myopic’ effect (Bushee 1998), and is argued that due to the large shareholding and interest in long term value creation, institutional investors have greater economic incentives to monitor the activities of the board more effectively.

In India, institutions (banks, financial institutions and mutual funds) owned about 10% of the shares of all listed firms in 2008. The shareholding by foreign institutional investors for the firms averaged 3% during the same time period. The institutional investment was found to be greater for large firms and for firms whose stocks were frequently traded (Sarkar 2010).

Prior empirical studies have found that institutional investors prefer to invest in firms with increased transparency (Bushee and Noe 2000; Aggarwal et al 2006). Some studies have found that greater institutional shareholding was associated to lower information asymmetry (El-Gazzar 1998, Bushee et al 2003), higher analyst following (O’Brien et al 1990), increased information flow and greater informativeness of stock prices.
Studies have also found that institutional investors influenced invested firms to improve their quality of reporting (Velury et al 1999). A positive relationship between institutional ownership and corporate disclosure was reported in some studies (Barako et al 2006; Bushee and Noe 2000).

Based on the above discussions it is expected that the presence of institutional investors would compel firms to increase disclosures due to the large ownership stake and greater incentives for monitoring corporate disclosures. Moreover as the information requirements of institutional investors are likely to be high, firms would provide greater disclosures to meet the expectations.

Another facet of ownership concentration examined in several empirical studies is the role of foreign shareholders. Prior studies have found a significant positive relationship between the proportion of foreign ownership and the level of discretionary disclosures (Haniffa and Cooke 2002). As foreign investors are more susceptible to expropriation by the managers or controlling shareholders (Jensen and Meckling 1976; Klapper and Love 2004) and they prefer to invest in firms that are transparent (Ahearne et al 2004). Besides, the cost of obtaining additional information would be higher for the foreign investors as compared to the domestic investors and hence the investment preference would be aligned towards firms that have a high degree of voluntary disclosure (Brennan and Cao 1997; Mangena and Tauringana 2007).

Country-level studies have indicated the preference of foreign investors to invest in countries with better disclosure (Klapper and Love 2004). Empirical studies that analyze the relationship between foreign share ownership and voluntary disclosure have proved the positive relationship
between the two variables in several countries (Barako et al 2006; Dahlquist and Robertsson 2001, Sweden; Lin et al 2012, Taiwan; Mangena and Tauringana 2007, Zimbabwe).

Based on the above discussions, it is evident that the pattern of shareholding in a firm would determine the extent of disclosures of a firm. Hence it is hypothesized that:

\[ H2 \] Ownership structure has a positive influence on the extent of discretionary disclosures

### 3.2.4 Board Characteristics and Discretionary Disclosures

The board of directors represents an important corporate governance mechanism to protect the interests of shareholders in a firm. The board is expected to fulfill its responsibility for management and control of the firm through its monitoring, advising, strategic and resource-provision role of the board (Daily et al 2003; Zahra and Pearce 1989). Though the board might delegate everyday decision-making and control to the managers, the right to hire, fire and compensate the managers remains with the board. The codes for effective corporate governance issued by countries worldwide have indicated the importance of the board in ensuring efficient corporate governance.

But, practical difficulties may arise due to factors such as the structure and composition of the board, presence of insiders on the board, leadership structure and the process to select board members. All the above mentioned factors determine the efficiency of the board as a corporate governance mechanism. As the board was perceived as a tool for monitoring the management behavior (Rosenstein and Wyatt 1990) it is expected to result
in greater discretionary disclosures. The characteristics of the board determine the efficiency of board functioning and board processes and hence form the foundation for all other activities of the board.

The structure of boards differs across countries due to legal requirements and country level factors (Shleifer and Vishny 1997; La Porta et al 1998). Boards in US and Europe are most often unitary (Guest 2009) while a two-tiered structure exists in Germany, Austria, France and Finland. In India, although a minimum board size of 3 is mandated by law, the number of members on the board is determined by the firm based on its needs. However, the maximum number of board numbers should not exceed the limit specified by it in the Articles of Association. If a firm desires to increase the size of the board beyond the specification of the Articles it can do so after appropriate procedures.

The size of the board has been found to impact the effectiveness of the monitoring role. A small board was found to be more effective in performing the monitoring role while a large board was found to be effective in the advising role (Jensen 1993; Dalton et al 1999). Though regulations prescribe a minimum board size, boards are generally larger than required by law.

Studies have reinforced the effectiveness of board as a corporate governance mechanism, to monitor the performance of a firm (Dalton et al 1999, Mak and Li 2001, Kiel and Nicholsan 2003, Guest 2009, Kathuria and Dash 1999, Lipton and Lorsch 1992). The resource-dependency theory suggests that the size of the board influences the effectiveness of the activities of the board due to the collective expertise and experience of the members. This is expected to result in effective processing and delivery of information
to stakeholders. Chen and Jaggi (2000) found that greater number of directors on the board reduced the likelihood of information asymmetry due to the collective expertise and experience of the board that resulted in greater information disclosure. However, In the French context, Lakhal (2005) found that the size of the board did not impact voluntary disclosure. Insignificant relationship between board size and discretionary disclosure was reported in studies by Cheng and Courtenay (2006) and Arcay and Vazquez (2005). It has been argued that large boards can become dysfunctional and increase the time and cost of coordination and processing information (Jensen 1993; John and Senbet 1998) due to free-riding, leading to inferior monitoring and lower voluntary disclosures.

The leadership structure existing in an organization has been found to be a determinant of the quality and extent of disclosures made by a firm (Farker 1992). The two key leadership roles in an organization are that of the CEO and the Chairman of the board. The CEO of the firm is expected to manage the operations of the firm while the Chairman leads the board of directors and is responsible for board meetings, setting agendas, employment of management personnel and deciding their compensation packages. The CEO is vested with operational responsibilities while the Chairman is required to address strategic issues.

In an ideal situation, it is expected that two individuals hold the roles. But it is not rare to find firms that have one individual assuming the dual role of CEO and Chairman of the board and is referred as ‘duality’. Although a dual leadership structure (CEO is also the Chairman) is expected to provide benefits of better monitoring, unity of command, stability, continuity, and focus in addition to reducing ambiguity (Daily and Dalton 1997, Coles et al 2001) it has been found to concentrate power and authority
in one individual, resulting in an environment conducive to detrimental use of power. Duality has been found to result potential conflict of interest and bias in decision making. Strong theoretical arguments support the separation of the decision and control functions of a large organization due to the complexity of the requirements.

Improved monitoring and governance role of the board with separate CEO and Chairman roles was found in several prior studies (Jensen 1993; Gul and Leung 2004, Rhoades et al 2000; Rechner and Dalton 1991; Haniffa and Cooke 2002). In the context of disclosure, separation of the roles of chairman and chief executive would be crucial to improve the quality of monitoring. As reported in prior studies (Jensen 1993; Goyal and Park 2002; Anderson et al 2004; Dechow et al 1996), boards with duality are generally expected to exhibit weaker monitoring capabilities. This would increase the chances of withholding information and may result in lower disclosures (Forker 1992). More specifically, duality would constrain and reduce the ability of the board to execute its oversight and governance roles that extend to the dissemination of corporate information to outsiders. The findings of prior studies suggest that boards in firms with dual leadership structure may not ensure a higher level of transparency and may conceal fraud, incompetence (Fama and Jensen 1983) and earnings management (Sarkar and Sarkar 2006). Some studies found no support for the relationship between duality and disclosure level (Ho and Wong 2001; Cheng and Courtenay 2004) but most of the studies have found negative relationship (Gul and Leung 2004; Haniffa and Cooke 2002; Huafang and Jianguo 2007).

The number of multiple directorships held by the members of the board is an important determinant of the efficacy of the board. It is crucial in determining the governance and monitoring effectiveness of the board. It has
been used in many studies as a surrogate for the expertise or quality of the board. The phenomena of multiple-directorships has also been referred to as the ‘busyness’ hypothesis (Ferris et al 2003; Sarkar and Sarkar 2009).

Two competing views about the relationship between multiple directorships and the effectiveness of monitoring exist. The resource-based view suggests that multiple directorships result in greater monitoring expertise due to knowledge gained from other boards (Fama and Jensen 1983). Multiple directorships have been found to provide information relating to new policies, trade secrets, practices of other firms (Haunschild and Beckman 1998) and economic trends and aspects of international business. These have been found to improve the effectiveness of the advising role. Additionally, multiple directorships have been found to enhance corporate control and effectiveness due to the additional insights into the outcomes of other companies (Turnbull 1997; Dahya et al. 1996). Literature posits that the number of multiple appointments serve as a proxy for high directorial reputation and directorial quality (Fama and Jensen 1983). The divergent view based on the secrecy-hypothesis suggests that multiple directorships would put the company at a competitive disadvantage (Davis 1993; Gray and Vint 1995).

Several empirical studies have found that too many multiple appointments might hamper the ability of directors to discharge their professional responsibilities effectively on corporate boards. Moreover, multiple-directorships results in reduced ability to attend board meetings and other committee meetings that are forums through which directors demand accountability from management (Sarkar and Sarkar 2009). Some studies have found the number of directorships to be positively related to the likelihood of financial statement fraud (Beasley 1996). The lack of sufficient
time for busy directors to discharge the professional responsibilities would compromise their ability to monitor the management on behalf of shareholders (Lipton and Lorsch 1992).

A study by Abdelsalam and Street (2007) in a sample of UK-listed companies found that boards with less cross directorships provided more timely corporate disclosures. A study by Haniffa and Cooke (2002) in Malaysia examined the relationship between busyness and voluntary disclosures and found insignificant results. As prior studies have indicated that busyness of the board, determined by multiple-directorships of the board of directors impacts the quality of monitoring and oversight, the impact of busyness on the extent of disclosures cannot be undermined.

However, in the Indian context, with greater family control and crossholdings, multiple-directorships was observed in many firms (Sarkar and Sarkar 2009) and was found to be associated with higher earnings management, indicating the ineffectiveness of the monitoring role. There are no studies in that focus on the relationship between busyness and discretionary disclosures in the Indian context. But, based on the above discussions it is expected that busyness of the board would have a negative impact on the extent of discretionary disclosures made by a firm.

The above arguments indicate that the board, through its monitoring role, strengthens the corporate governance mechanism to ensure timely and adequate disclosures. Hence it is hypothesized that

H3 : Board characteristics have a positive effect on the extent of discretionary disclosures
Board characteristics were also expected to influence the functioning of the board and hence the following hypothesis was postulated to examine the effect.

$H_{3a}$: Board Characteristics have a positive effect on the functioning of the board

### 3.2.5 Board Functioning and Discretionary Disclosures

The functioning of the board determines the effectiveness of the board as an internal governance mechanism. The major roles of the board, monitoring, advising and strategic role have been found to be impacted by the effectiveness of board functioning (Zahra and Pearce 1989). Studies have indicated that the functioning of the board is determined to a great extent by the size of the board and the leadership structure of the board (Ong and Wan 2008). The effective functioning of the board in prior studies was inferred from certain board aspects (Finkelstein and Hambrick 1996) such as independence of the board and the intensity of the board’s activity.

The presence of independent directors on the board is considered to be vital for the unbiased functioning of the board to protect the interests of the shareholders and hence is considered an effective mechanism of corporate governance. Theoretical and empirical literature pronounces that boards composed of a higher proportion of outside directors have better monitoring over the management (Fama and Jensen 1983). It was found that independent directors add value to an organization by increasing accountability, providing independent judgement, increasing the network of business connections and moderating the power of the CEO and Chairman (Pass 2004, Roberts et al 2005). Independence of the board was found to impact several board
decisions such as negotiation of tender offers, firing non-performing CEOs and resistance to hostile takeovers (Weisbach 1988, Kosnik 1987, Byrd and Hickman 1992). The effects of boards with higher proportion of outside directors was found to result in lower earnings management, reduced likelihood of fraud and improved informativeness of earnings (Beasley 1996; Peasnell et al 2005; Klein 2002; Sarkar ans Sarkar 2009). The Cadbury Committee recommended that the majority of the board should comprise of non-executive independent directors. The Hampel Committee (1998), SOX (Sarbanes 2002) and the OECD Principles of Good Governance (OECD 2004) have recommended similar requirements, stressing the importance of independent directors.

In India, the ‘Kumar Mangalam Birla Committee Report on Corporate Governance’ (Birla, 2000) provided the impetus favoring independent directors. An independent director, in the Indian context is not a substantial shareholder of the firm (2% or more shares of the firm), is not related to the promoters or persons occupying managerial positions at the board level, has not been an executive of the firm for the preceding three years, does not have any material pecuniary relationship with the firm or its subsidiaries and is not a supplier or consultant of the firm. Law also provides a definition about the term ‘related to the promoter’ in detail to avoid people from the same family from being appointed as independent director. It recommended that the board of a listed firm should comprise of not less that 50% non-executive directors. However, the committee allowed for boards with a non-executive chairman to have not less than 1/3rd independent directors. This was made mandatory through the Clause 49 of the Listing Agreement. The same was reiterated by the Narayana Murthy Committee.
Most empirical studies have observed that greater board independence was linked to higher discretionary disclosure (Chen and Jaggi 2000; Buijaki and McConomy 2002, Leung and Horwitz 2004; Cheng and Courtenay 2006; Huafang and Jianguo 2007, Lim et al 2007 and Donnelly and Mulcahy 2008). However, some studies that examined the relationship between board independence and a direct measure of voluntary disclosure found counterintuitive (Eng and Mak 2003) and insignificant results (Ho and Wong 2001). Though results are mixed, the emphasis on independent directors as an effective corporate governance mechanism has been stressed by several reform committees and supported by several empirical studies. It is expected that greater board independence through better monitoring would reduce information asymmetry and expropriation through better disclosure. Based on the above discussion it is expected that a board with greater independence would have a positive impact on the extent of discretionary disclosures.

The diligence of the board or the intensity of board activity has remained an important indicator of the monitoring and oversight role of the board. One measure of the intensity of board activity is the frequency of board meetings (Brick and Chidambaram 2010). The number of meetings held by the board indicates the activeness and effectiveness of the board (Gillan 2006). Boards that meet more frequently were found to perform their duties diligently (Lipton and Lorsch 1992) and result in better firm performance (Brick and Chidambaram 2010, Adams 2005). On the contrary, some studies found that boards meet more often during periods of turmoil (Vafeas 1999), poor performance (Adams 2005), periods of increased litigation risk or in circumstances of major activities such as merger and acquisition (Brick and Chidambaram 2010).
Research examining the effect of board activity on earnings management found a negative relationship indicating that active boards are associated with lower earnings management (Ebrahim 2007; Xie et al 2003). In India, Sarkar et al (2008) indicated that diligent boards were associated with lower earnings management. A study by Nelson et al (2010) examining the relationship between board activity and voluntary disclosure of executive stock option and found an insignificant positive relationship. There is lack of empirical evidence that examined the direct influence of board activity intensity on voluntary disclosures. However, drawing from the results of research in earnings management in India and other countries it is expected that active boards are more effective in the monitoring role leading to more voluntary disclosures.

It is expected that boards that are independent and function effectively would ensure effective communication of information to the stakeholders and hence it is hypothesized that,

**H4** : Board functioning has a positive effect on the extent of discretionary disclosures

### 3.2.6 Audit Committee and Discretionary Disclosures

It is customary for the board to constitute several committees such as the audit committee, nomination committee, remuneration (compensation) committee and executive committee to perform specific duties. It ensures better utilization of time and efficient implementation of board policies. Several empirical studies have proved that existence of board committees, its structure and its performance improved the corporate governance climate of the firm (Harrison 1987; Jemison and Oakley 1983). It is also expected to
increase legitimacy, speed and quality of management (Zahra and Pearce 1989) and monitoring.

Audit committee is the most important committee of the board. It has general oversight responsibility for the firm's financial reporting and internal control process. It ensures that the firm has adequate internal control mechanisms to prevent fraudulent financial reporting (Feló et al 2003). It also has responsibility to retain and oversee the performance of the external auditor of the firm. The actions of the audit committee are subject to external audit by the auditors.

In India, it is mandatory for all firms to have an audit committee. Regulation also specifies that the chairman should be independent and the size of the committee should not be less than three. It is also stipulated that all members of the audit committee should be non-executive, with at least 2/3rd independent directors. It is mandatory for at least one member of the committee to be financially literate. The recommendations are based on the notion that an appropriately structured audit committee would act to ensure high quality financial reporting.

The presence of an audit committee has been found to result in better monitoring (Forker 1992; Ho and Wong 2001; McMullen 1996). An audit committee that is well resourced is essential for its effective functioning (Mangena and Pike 2005). A larger audit committee is also more likely to uncover and resolve problems in the financial reporting process (Bedard et al 2004) and therefore an important factor for a firm's corporate reporting process (Klein 2002). The size of the audit committee has not received as much research attention as size of the board. However, an audit committee may not function similar to a board and in most cases are limited in size.
Hence coordination problems arising in large boards may not be relevant for audit committees. Extending the findings that large boards are better monitors, it is expected that an audit committee with more members would indicate better resources in terms of varied expertise and experience. This would improve the quality of oversight and monitoring and thereby the quality of reporting resulting in more discretionary disclosures.

As the role of the audit committee is to ensure accurate corporate reporting and to detect accounting irregularities, it is that the audit committee should be diligent to monitor the process efficiently (Karamanou and Vafeas 2005). It is essential for the members of the audit committee to devote more time to ensure that fraud and accounting irregularities do not occur. The number of meetings of the audit committee has been used in prior studies as a proxy to measure its diligence (Kelton and Yang 2008). Empirical evidence has found a negative relationship between the frequency of audit committee meetings and earnings management (Cornett et al 2009). In disclosure research, Bronson et al., (2006) found a positive association between the meeting frequency of audit committees and voluntary disclosure of management reports on internal controls. Kelton and Yang (2008) found a significant positive relationship between a firm’s internet financial reporting and audit committee diligence. Li et al (2012) also reported positive relationship between the frequency of audit committee meetings and intellectual capital disclosures. Extending the empirical findings, it is expected that firms with a diligent audit committee would have better financial transparency and higher voluntary disclosures.

These demonstrate the significance of the audit committee as a corporate governance mechanism and hence it is hypothesized that
H5: Audit committee characteristics have a positive effect on the extent of discretionary disclosures

3.2.7 Firm Characteristics and Discretionary Disclosures

Prior studies have found that firm characteristics have a significant effect on the extent of discretionary disclosures made by a firm. The effect of characteristics such as size of the firm, profitability of the firm, leverage, the number of years for which the firms has been in existence and the growth of the firm have been examined widely in prior research.

The size of the firm has been found to be a significant factor impacting the disclosures of firms in many studies (Cerf 1961; Malone et al 1993; Ahmed and Nicholls 1994; Hossain et al 1994; Narasimhan and Vijayalakshmi 2006; Srinivasan 2006). The major reason identified for the positive relationship was the cost of collecting and disseminating data, which would be lower for larger firms (Cerf 1961; Ahmed and Nicholls 1994). The need for capital, availability of adequate expertise, financial resources, availability of information, greater analyst following and stakeholders ((Mahajan and Chander 2007) were identified as some reasons for the positive association in prior studies.

The number of years for which the firm has been in existence was found to be a significant determinant of discretionary disclosure. Older, well-established firms were found to have greater discretionary disclosures than younger firms. Research has attributed this to three factors (Owusu-Ansah 1998). First, older firms may have a more evolved system of disclosure that would result in increased disclosures. Second, older firms would have a broad scope of operation and it would have more information to disclose (Mahajan
and Chander 2007). Younger firms would not have as much past history as older firms to disclose. Third, younger firms would perceive loss of competitive advantage due to disclosure and hence may not divulge greater discretionary information. However, older firms may not have similar perceptions creating dissimilar disclosures.

Firms with higher profitability disclose more information than companies with lower profits for various reasons. Research has found that profitable firms disclose more than less profitable firms (Wallace and Naser 1995; Raffournier 1995; Srinivasan 2006; Mahajan and Chander 2007) as they possess more positive information to communicate and have greater leverage by disclosure of such positive information (Wallace and Naser 1995).

Higher levels of leverage indicate higher agency cost and hence firms with higher leverage are expected to have greater disclosures to reduce agency cost and information asymmetries. This suggests a positive association between leverage and the extent of voluntary disclosure (Chow and Wong-Boren 1987 and Wallace et al 1994). However, some studies have reported a negative relationship between leverage and disclosure (Abd-Elsalam and Weetman 2003). This was attributed to the fact that firms with greater leverage rely less on capital markets to raise funds and hence have lower disclosures. Few studies examining leverage and disclosure have found insignificant results (McKinnon and Dalimunthe 1993; Raffournier 1995; Aitken et al 1997; Depoors 2000; Narasimhan and Vijayalakshmi 2006).

Firms that have high growth have greater need for capital creating a greater need for transparency and disclosure. Hence it is likely that high growth firms have more disclosures. However, based on the proprietary cost
hypothesis it can be argued that firms with high growth would have greater competitive disadvantages due to disclosure and hence would have lower disclosures. However, the effect of growth on the disclosure policy of the firm cannot be undermined as it has an impact on the overall efficiency of the firm.

Based on the above arguments, it is hypothesized that,

\( H_6 \) : Firm characteristics have a positive effect on the extent of discretionary disclosures.