Corporate Governance: An Indian Perspective on Disclosure and Transparency Issues

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ABSTRACT

The fundamental base of corporate governance is the agency theory which states that there is separation between ownership and control. This separation creates divergence in the interests of various parties involved including management and stakeholders, generating agency problem. In particular, better disclosures are considered to be the better way to reduce the agency problem. Corporate governance appends transparency and disclosure of corporate structure to ensure accountability of management towards shareholders. This paper sets out to examine the disclosure practices adopted by the Indian banking sector. A composite disclosure checklist consisting of more than 104 items is developed including both mandatory and non-mandatory items. Disclosure checklist is formulated on the basis of existing literature, various corporate governance index formulated by previous researchers, norms of Clause 49 of Listing Agreement. The recommendations of Clause 49 were incorporate by Kumar Manglam Birla Committee laid down by SEBI. The findings of the study indicates that Indian banking sector is compliant with the mandatory disclosure practices but not enough to hit the highest point. Also, banks are on the path to the adoption of and making disclosures regarding voluntary recommendations. This paper is an attempt to contribute to the academic literature by illustrating that a strict check by regulatory authorities brings the prospective for high compliance regarding disclosure and transparency.

Introduction

India is regarded as one of the fastest growing economies among the global economies. As per Organization for Economic Cooperation and Development, Indian economy has surpassed to 3rd position in the world in terms of purchasing powers parity and is tenth largest in terms of nominal GDP (World Bank Ranking). Financial system of India plays a crucial role in the economic development of the nation. Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from the surplus to deficit sectors. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. But after the nationalization of major banks in 1969 and 1980,

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reforms were introduced to increase efficiency, productivity and profitability, accountability and financial soundness of the banking sector. With the motive of imparting strength, these reforms also surpluses the banks with functional autonomy and operational flexibility (BIS).

BASEL committee on Banking Supervision considers transparency as the key element of an effectively supervised, safe and sound banking system. It regards that adequate public disclosures facilitates a more efficient allocation of capital between banks since it helps the market accurately assess and compare the risk and return prospects of individual banks. But during recent time the goal of achieving transparency has become more challenging as the activities of banks have become more complex and dynamic. Many banks now have large-scale international operations and significant participation in securities and/or insurance businesses in addition to traditional banking activities. Asian financial crises also forced the regulatory authorities to revise again and again their policy frameworks, particularly corporate governance, disclosures and transparency. Indian economy is also among one of those who are regularly reviewing and improving their regulatory frameworks.

The corporate governance is the comprehensive system of directing and controlling the affairs of a corporation. It refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. The basic governance issues mainly relate to the Board, and its effectiveness measured by its performance, and accountability ensured by proper disclosure and transparency. Corporate disclosures are determined by the business environment prevalent in the country. The objective of the disclosures is to provide relevant, reliable, adequate, truthful, timely, unbiased and comparable information to the related stakeholders so that they can make out right decisions, form informed judgments and opinions regarding the business entity they are attached with. Disclosures related to financial reporting provides the stakeholders with most available data on public corporations' economic activities hence serve as vital function in the corporate governance process. Disclosure of quantitative and qualitative information of financial and non-financial nature and governance practices go a long way in ensuring commitment from various stakeholders and enhancing value to it. With this concept in view, this study will investigate the disclosure practices adopted by the banking sector in India.

Theoretical Framework

The corporate governance environment varies from country to country depending upon law, professional bodies, stock exchanges and regulatory authorities. The Indian Banking Industry is in the hands of a very meticulous regulatory and supervisory framework. Reserve bank of India is the primary regulatory body under whose supervision the Indian Banking Industry operates. The legal framework of Indian banking system including the financial reporting and disclosure regulations are governed by the umbrella acts – Banking Regulation Act 1949, Companies Act 1956, guidelines of Securities and Exchange Board of India (SEBI) and Institute of Chartered Accountant of India (ICAI). The Banking Regulation Act 1949 provides a framework for regulation and supervision of commercial banking activities. Along with the central banking functions, RBI plays a pivotal role in promoting the sound banking system in India. The non-

monetary functions of the central bank are to improve the level of disclosure and transparency in banks' annual accounts and also to supervise the functioning of banks. Both the Banking Regulation Act 1949 and Reserve Bank of India Act 1934 bestow the RBI with wide powers of supervision and control over commercial banks.

Regulatory Reforms

In India, it was CII which came out for the first time with a 'Desirable Corporate Governance Code' in 1997 which was voluntary in nature. Securities and Exchange Board of India constituted the Kumar Manglam Birla Committee on May 7, 1999 under the chairmanship of Shri Kumar Manglam. The motive behind the constitution of the committee was to promote and raise the standards of corporate governance. Based on the recommendations of the committee a new clause 49 was incorporated in the Stock Exchange Listing Agreements ("Listing Agreements"). The recommendations were made applicable to all companies in the BSE 200 and S&P C&X Nifty indices, and all newly listed companies, as of March 31, 2001. Clause 49 of Listing Agreement enforces to have a separate section on corporate governance in the annual reports. This section should include nine sub-sections dealing with the board of directors, audit committee, remuneration of directors, shareholders' grievance committee, general body meeting (board procedure), disclosure of related parties, means of communication, general shareholders' information, others including risk management, management discussion and analysis, information and compliance respectively. A compliance certificate of corporate governance must be obtained from the auditors or practicing company secretary annexed with the director's report must be sent to the shareholders, and the stock exchanges along with the annual report of the company.

In addition to SEBI requirements on corporate governance in the form of clause 49 in the listing agreement other economic and corporate legislation have bearing, directly or indirectly, on the functioning of corporate sector in India. Non-compliance of which can lead the companies to bear the penalties and strictures imposed by the regulatory authorities.

Literature Framework

The fundamental base of corporate governance is the agency theory which states that there is separation between ownership and control. This separation creates divergence in the interests of various parties involved including management and stakeholders, generating agency problem. In particular, better disclosures are considered to be the better way to reduce the agency problem. Corporate governance appends transparency and disclosure of corporate structure to ensure accountability of management towards shareholders. Williamson (1985) provided the framework for relating disclosure quality to corporate governance. Hossain (2008) empirically investigated the extent of both mandatory and voluntary disclosures by Indian Banking companies. The study considered both mandatory and voluntary disclosures and revealed that Indian banks are much compliant with the mandatory disclosures but lagging behind in disclosing the voluntary items. The study attempted by Wang et al. (2008) has scanned the data of annual reports of Chinese listed firms to empirically examine the determinants of voluntary disclosures. The results revealed that firm performance, foreign ownership, state ownership and reputation of engaged auditor are positively associated with the level of voluntary disclosures. Hossain and Hammami (2009) set out to examine empirically the determinants of voluntary disclosures in the annual reports of 25 listed firms of Doha Securities Market in Qatar. The study reported the results of both company

specific and voluntary disclosures of the selected sample. The findings indicate that age, size, complexity and assets-in-place are significant in explaining the voluntary disclosures. Broberg et al. (2010) explained the variation in the content on information in voluntary disclosures in 431 listed companies of Stockholm stock exchange. The findings support that the size and debt ratio are positively correlated with the content of information in voluntary disclosures. The results also showed that corporations with a low share of management ownership, and those with foreign ownership and international listing have a positive effect on the content of voluntary disclosures. Cheung et al. (2010) addresses the matter of transparency among the Chinese listed companies. To assess these companies' authors constructed a transparency disclosure index based on the OECD principles. The results of the study revealed the positive relationship between the disclosures and market valuation and that too with the voluntary disclosures. Allegrini and Greco (2011) considered the seven variables of corporate governance and among those showed the positive impact of board structure and audit meetings on the level of disclosures while significant negative relationship with CEO duality. Hermalin and Weisback (2012) argued that disclosure as well as governance reforms should be seen as a two edged sword. By applying a model to study the disclosures, the study propound that greater disclosures tends to raise the executive compensation and can create additional agency problems. Bhasin et al. (2012) investigated the extent and determinants of total voluntary disclosures and their categories in financial and non-financial reports of banking companies of Kazakhstan Stock Exchange. The empirical results suggest that the number of outside directors and increased bank size has most significant positive impact on disclosure scores. The findings did not provide evidences regarding any improvement in voluntary disclosures over time.

Objectives of the study

The study sets out to investigate the level of disclosure practices adopted by the banks in India. And in addition to mandatory requirements the study will also explore the level and extent of voluntary disclosures made in the annual reports by the banks.

Methodology

The study is focused on the Indian banking sector. S & P BSE Bankex included 13 banks ranked top in position formed the sample for the study. Annual reports for the year 2012-2013 and the websites of the sample banks became the major source of information and data collection. These annual reports were collected from the websites of the banks. The information scanned out of the annual reports and websites was used to determine the disclosure level and quality of governance of the selected banks as per the index so developed for the purpose.

Index Formulation and Scoring

Parameters for the formulation of Index are selected from Clause 49 of Listing Agreement. Clause 49 was one of the major mile stone in the history of reforms related to corporate governance in India. Securities and Exchange Board of India provided the mandatory as well as non-mandatory recommendations on nine sub-heads mentioned above. Besides these recommendations, parameters are also based on existing literature, various corporate governance index formulated by previous researchers and guidelines of other regulatory authorities. A total of 104 items are included in the disclosure checklist among which 15 statements are voluntary or non-mandatory recommendations of the regulating bodies. A list of items included in the disclosure checklist / index is presented in table 1.

Table 1: Items included in the disclosure index

Items of Disclosure Index	No. of Items
A. Mandatory Disclosures	
A1. Board Composition and Procedures	27
A2. Audit, Remuneration and Shareholders' Committee	21
A3. Transparency and Disclosure	25
A4. Shareholders' Right	16
B. Non Mandatory/ Voluntary Disclosures	15
Total Items	**104**

In previous studies related to disclosure levels both weighted and un-weighted index were formulated. In weighted Index, scores are assigned to the items between zero and one on the basis of weightage of the items likewise adopted by Nasha (2007), Htay(2012). While in case of un-weighted index, researchers Cooke (1991 and 1992), Hossain et al. (1994), Ahmed and Nicholls (1994),Hossain (2008) adopted dichotomous procedure of assigning scores i.e. to assign zero to items which are not disclosed in the annual reports and assigning one to those which are disclosed. The principle behind the un-weighted method is that each and every item has been assigned equal weights. In this study, un-weighted method of scoring the index items is used to assign the scores to the checklist items. The total score of un-weighted disclosure method is additive (Cooke, 1992) as follows:

$$TD = \sum_{i=1}^{n} di$$

Where,

d = 1 if the item i^{th} is disclosed

0 if the item is not disclosed

n = number of items

Findings

Relation between governance and disclosure practices can well be understood by the words of Sir Adrian Cadbury, "*the disclosure is the life-blood of governance, and transparency the aim.*" Indian banking sector is compliant with the mandatory disclosure practices but not enough to hit the highest point. It is highly expected from the Indian banking sector to disseminate proper information concerning their plans, policies, functioning and performance so that users can have informed opinions and judgments. In Indian context, banking industry is highly regulated by the regulatory authorities and the possibility of higher disclosures regarding corporate governance applied by SEBI and other authorities shoots up. Indian banking sector has also step forwarded in the adoption of voluntary practices and disclosing them in their annual reports. Table 2 reports the level of mandatory as well as voluntary disclosure disclosed by Indian public and private sector banks.

Table 2 : Level of Mandatory and Voluntary Disclosures

Public Sector Banks	Mandatory Disclosure Scores (89)	%age	Voluntary Disclosure Score (15)	%age	Private Sector Banks	Mandatory Disclosure Scores (89)	%age	Voluntary Disclosure Scores (15)	%age
State Bank of India	67	75.28	06	40.00	ICICI Bank Ltd.	67	75.28	08	53.33
Punjab National Bank	54	60.67	07	46.67	HDFC Bank Ltd.	70	78.65	12	80.00
Bank of India	57	64.04	06	40.00	Kotak Mahindra Bank Ltd.	73	82.02	06	40.00
Canara Bank	58	65.17	07	46.67	Federal Bank Ltd.	63	70.79	08	53.33
Bank of Baroda	63	70.79	08	53.33	YES Bank Ltd.	60	67.41	06	40.00
Union Bank of India	66	74.16	11	73.33	Axis Bank	70	78.65	09	60.00
					Indusind Bank Ltd.	63	70.79	06	40.00

Banks are very obedient with the disclosures related to the composition of board of directors containing almost 50% non-executive directors, their experience and qualifications. Board of directors have to execute the strategic role to exercise oversight over the business operations and to ensure conformity with the legal framework, financial accounting and reporting systems and also to maintain credibility with stakeholders by making adequate and timely disclosures. So, it is of immense importance to follow up the rules regarding board of directors strictly and banks are doing so. Moreover, banks are chasing the directorship and membership of directors in various committees' criteria firmly. Indian banking sector is also submissive in following the corporate governance guidelines imposed by SEBI and other authorities. Proper disclosures related to shareholders' right, annual meetings, compositions of the committee members, criteria of making payments to directors, penalties and strictures, investors' grievances, and whistle blower policy are made. Banks are on the forefront in maintaining their websites and displaying information to their customers. Since this sector is under strict supervision of regulators, more transparency is expected from them. A guideline issued by Ministry of Corporate Affairs regarding sending e- annual reports in order to follow the green initiatives is still being not adopted by most of the banks. Banking sector in Indian context is also lagging behind in revealing information related to the voting procedures taken up and evaluation system for non-executives. No disclosure regarding succession plan for Chief Executive Officers were made and imparting light

on the other side of public sector banks most of the public sector banks has sidelined the recommendation of having CEO and Chairman/ Chairperson two different persons.

Conclusion

Corporate Governance Reforms in India started only with the voluntary recommendations but passing time span and increased incidents of financial distresses forced different authorities to impose mandatory recommendations. But still optimism about voluntary disclosure enhanced the transparency, which reduces the information asymmetry between the insiders and outsiders of the organizations. The voluntary aspect allows management discretion in deciding the content of information to disclose that is recommended as best practice (Cheung, 2010). Indian Banks are in practice to disclose non-mandatory recommendations of Clause 49 but not to the acceptable extent. However, some information related to risk management committees, asset liability committee and corporate social responsibility have been adequately disclosed in the annual reports. But banks need to go beyond the limits of mandatory disclosures, reduces the information asymmetry and bring more transparency to their stakeholders.

Disclosures indexes developed to measure the level of disclosure unveiled and quality of governance practices by the banking industry can be helpful in ascertaining their position in these regards. At present, the disclosures of employee related information as well as that on social and environmental issues is minimal in most cases. The concerns should disclose more on such matters, in terms of employees as intellectual assets and the latter as their social responsibility contributions. Improved disclosure in this regard will result in better perception of corporate image by the public. The information regarding futuristic nature related to planned operations needs to be disclosed in clear terms. This information is useful for investors in making choices for the future, as past information has its limitations for future decision making. Whatever has become mandatory through SEBI regulations should be followed both in letter and spirit. Moreover, viewing voluntary corporate information from the development of information disclosure system, it is complementary to mandatory information system and has its own importance. Voluntary information builds confidence to the investors (Hossain and Hammami, 2009), so the corporations should be transparent enough in making it public. More disclosure and transparency in corporate affairs, and better conduct of the same establish the quality of governance and will enhance the standing of the concerns in the long run.

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