INTERNATIONAL JOURNAL OF RESEARCH AND ANALYSIS VOLUME 5 ISSUE 2 ISSN 2347-3185

2018

THE ROLE OF CORPORATE DISCLOSURE IN STRENGTHENING CORPORATE GOVERNANCE AND INVESTOR PROTECTION: A COMPARATIVE STUDY OF INDIA AND USA.

***ANANYA RITUAM**

As compared to few years ago, now when the stock market interests have heightened up, there is no dispute as to the importance of corporate governance. With most of the highly reputed business houses and global financial institutions keeping the shareholders and investors uninformed about their financial position, the disturbance in the financial markets globally can be related to weak corporate disclosure and governance regime. Corporate malpractices, scams and frauds are not new to India or to the world. Unlawful and unscrupulous activities are being followed and practiced by individuals and institutions at every nook and corner of the world. Fraudsters knowing them to be so commit illegal practices. Corporate Scandals and scams always occur in an organized form with the team of management and auditing firm, that is to say, frauds never take place in isolation. Several corporate failures with various companies have been witnessed by India in the past. Satyam scam was the biggest ever in the list with a huge amount of accounting fraud committed. By far we have seen that disclosure and transparency play an important role in better governance of a company.[1]

INDIA

India has adopted some of the best suitable rules and regulations under its corporate governance regime to tighten and scrutinize the disclosure mechanism in order to facilitate better investor protection. India, indeed, has an elaborate system of laws governing corporate governance. With the advent of new companies act, 2013 and new regulations of 2015 by the Government, share market regulator, SEBI, there is no doubt that corporate India has been continuously updating and pushing itself hard to raise the standards for corporate governance. But the question is have the corporate disclosure governance standards improved to the

[1] Mohit Baijal, *Role of Financial Reporting & Disclosures in Corporate Governance*, Available at http://iica.in/images/Knowledge_IICA_Reserch_and_publications.pdf (Last visited on March 12,2016)

desired levels. Are corporate financial disclosure rules that determine what a company must tell investors about its operations and results robust?[2] Very recently, SEBI, in an attempt to further enhance transparency in corporate corridors, had made it mandatory for promoters to announce their pledged shares for the public.[3] Pledging of promoters shares has been commonplace in the history of corporate India and, as it was not earlier mandatory on them to disclose the amount of shares pledged, shareholders were left guessing. Now that this disclosure has been made mandatory, shareholders will have a better idea of the financial stability and ownership status of the companies they invested in. As not much time has passed since the new disclosure regulations under Companies act, 2013 have been implemented and also with the implementation of the very recent SEBI guidelines, 2015 it would be arduous to peruse and inspect the effects of the disclosure standard on the corporate governance regime. And as to how it would affect the investors. However, the manner and fashion in which the regulations have been fabricated, on the face of it, it appears to be quite well built and efficacious. The companies and auditors have put in greater checks to prevent fraud and there is much more vigilance now. Lots of checks and balance methods have been instituted along with the collusion of employees, owners, external agencies, accountants, to curb and deter frauds of the magnitude of Satyam scale. There is now greater awareness and respect for the various facets of corporate risk among companies and boards.[4] Most organisations have digitised their business processes and strengthened internal controls to prevent and detect frauds. Boards have also started linking the compensation and incentives of top executives to how well they manage mission-critical exposures.[5] Indeed, board/audit committees of companies have powers of increased oversight of corporate governance. Boards must have at least one woman director. Allowing companies to increase the maximum number of directors on their boards by way of a special resolution would ensure greater

---

[2]K V Kurmanath, *How Satyam scam raised the bar of corporate governance*, THE HINDU BUSINESS LINE, Available at http://www.thehindubusinessline.com/companies/how-satyam-scam-raised-the-bar-of-corporate-governance/article7085855.ece (Last visited on March 22, 2016)

[3] *SEBI set to overhaul disclosure norms for better monitoring*, ENS ECONOMIC BUREAU, Available at http://www.newindianexpress.com/business/news/Sebi-Set-to-Overhaul-Disclosure-Norms-for-Better-Monitoring/2015/07/13/article2916973.ece. (Last visited on March 22,2016)

[4] R.Uma Devi, *Corporate Reporting Practices and Corporate Governance In India: An Analysis*, The INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT (ISSN 2321 –8916)

[5]Izyani Wan, Sulon Zunaidah , *Corporate Governance Mechanism and Extent of Disclosure: Evidence from listed companies in Malaysia*, 3(4) INTERNATIONAL BUSINESS RESEARCH (2010) 216-228.

flexibility to companies. Companies Act 2013 sets out an advanced framework for board functioning by division of core board functions and their delegation to committees of the board. While the audit committee and the nomination and remuneration committee provide the back end infrastructure for boards, the stakeholder's relationship committee and CSR Committee have been entrusted with the task of interaction with key stakeholders. Irrespective of their function, each of the committees would act as a "check and balance" on the powers of the board, by ensuring greater transparency and accountability in its functioning.[6]Measures relating to disclosures of related party transactions and approvals for such transactions is one such area which is intended to prevent directors, key managerial persons from taking undue advantage of their position for their personal benefit and ensure transparency in dealings of the company. The general presumption is that shareholders interests are compromised in related party transactions and goods or materials are low prices exchanged to related parties. Such transactions are tax evading. Hence, the CA act mandates approvals of board and shareholder, disclosure of such transactions and imposes penalties for non compliance of relevant provisions.

The basic aim behind amendments and implementation of new SEBI guidelines of 2015 was to help reduce the compliance burden on individuals and the companies, as disclosures made under different norms would be integrated so as to reduce the number of times the same disclosure is required to be made. Sebi also undertook steps to create awareness among listed companies for ensuring better compliance culture, besides strengthening the monitoring of listed companies by implementation of norms for Corporate Governance. SEBI amended the Clause 36, a 16 year old regulation with respect to continuous regulation to ensure that disclosure is not only timely but also adequate. The reason behind such implementation was clause 36 of listing agreement was the most misused clause by companies and SEBI attempted to plug this loophole. According to SEBI "the events/information can be said to have occurred when a listed entity becomes aware of the events/information, or as soon as, an officer of the entity has, or ought to have reasonably come into possession of the information in the course of the performance of his duties."

---

[6]Sulphey MM., Janardhanan Rajesh ,*The Position of Indian Companies in the Quest for Corporate Governance,* 4(2)CONTEMPORARY MANAGEMENT RESEARCH (2011) 1-8

Another recent change is that Auditors have come under intense scrutiny , i.e. they have to see to it that every internal financial control prescribed under the Companies Act is followed by a company, among other things. Examples of few of the many regulations instituted by the regulatory bodies, no doubt reflects the legislatives intention in building a robust corporate governance framework with strong disclosure standards, But are these enough? Even before the Satyam scam, India's financial reporting standards were fairly strong. But then where did the gap lie which led to the corporate failure. According to my view, the difficulty lay with weak enforcement and plenty of loopholes in the system which are expected to be resolved and addresses to with the advent of new rules and policies. The main obstacle is that most Indian companies are controlled by promoters, according to industry watchers. Independent directors are only independent on paper. [7] Relationships/connectivity between promoters and independent directors and also high remuneration levels mainly undermines the true independence of directors. This does not mean companies and independent directors are ignorant of the tougher regulations created post Satyam. By defining the responsibility of the independent director, the Companies Act has laid out the ramifications if the role is not taken seriously.[8] Also the stern and stringent rules are the reason that many professionals are turning to consultancies for advice and training before taking up the role of independent directors. Many firms are even drawing up new contracts which define the exact time the director needs to spend. Although, India still has has a long way to go in actually manifesting as to how far have the new regulations impacted upon in a positive way in enhancing investor protection and curbing frauds, India's corporate governance system is still regarded as among the best in emerging markets.[9] And investors are willing to vote with their legs. There has been a mass exodus from companies considered less transparent in recent weeks to those judged as following best practice. According to me, "Investor protection issues and Corporate crime in India can't be addressed by more laws or indeed more governance, but what needs to be done is rapid and forceful

---

[7]Rica Bhattcharyya ,Sachin Dave, *Lesson from Satyam: Corporate governance evolves, not execution*; ECONOMIC TIMES BUREAU, Jan 7, 2016, 05.39AM. Available at http://articles.economictimes.indiatimes.com/2016-01-07/news/69590053_1_auditors-governance-satyam-computer-services

[8]Anurag Pahuja, B S Bhatia, *Determinants of Corporate Governance Disclosure: Evidence from Companies in Northern India.* 9(3) THE IUP JOURNAL OF CORPORATE GOVERNANCE (2010) 69-88

[9]Klai Nesrine, Omri Abdel, *Corporate Governance and Financial Reporting Quality: The case of Tunisian Firms*, 4(1) INTERNATIONAL BUSINESS RESEARCH (2010) 158-166.

action against the perpetrators. Despite the regulatory efforts of SEBI and CLB to discipline the corporate, yet we are still in the nascent stage in the journey towards achieving quality in management of companies and reaping the benefits of the umbrella regulations.

USA

Coming to the corporate disclosure governance standards of US, it has one of the best disclosure and governance regime and its standards are generally taken and imbibed by other countries in maintaining their standards.

"As officers of public companies, you are keepers of the public trust, not only for your own company, but also ultimately for the entire market. My hope is that the extensive governance reforms we are in the process of implementing will provide an opportunity for companies to engage in real self-examination and learning regarding what it takes to be a good corporate citizen."[10]

SEC Commissioner Cynthia Glassman

It has been 14 years since the enactment of the Sarbanes Oxley Act and heightened regulations under the SEC, which gives quite ample time to analyse whether the Sarbanes-Oxley has been successful in preventing all bad actors from defrauding investors? Well, it's impossible for any law to accomplish it in whole. But it has definitely deterred such activity. Sarbanes Oxley Act is widely acknowledged for improving and strengthening at least two major areas of investor protection: (1) Responsibility and accountability of the Chief Executive Officer and Chief Financial Officer in matters relating to all financial disclosures and related controls; and (2) expanded professionalism and engagement on the part of corporate audit committees. Yet the financial crisis of 2008, still questions the overall value of such provisions.[11] However, the enhanced regulations of SEC and Sarbanes Oxley Act have prevented the fraudsters and perpetrators with the intention to seek to mislead the

[10]Speech by SEC Commissioner: Sarbanes-Oxley and the Idea of "Good" Governance. Available at https://www.sec.gov/news/speech/spch586.htm

[11] Wendy Semel, *Recent Developments And Proposals In Corporate Governance In The United States*, 9TH EUROPEAN CONFERENCE ON CORPORATE GOVERNANCE

market with unlawful activities and misleading numbers. The public company internal controls are now much more efficacious; independent auditors comply with stronger standards and also have an independent regulator to oversee their efforts on behalf of investors and other stakeholders; audit committees have been now given with the duty in overseeing the audit and financial reporting and hence should be much competent; and the Securities and Exchange Commission must now spend more of its resources in reviewing the quality of information that companies provide to the market.[12] The act also increased heavy penalties in case of false financial reporting.

However, when evaluating the overall effectiveness of SARBANES OXLEY ACT, a vital consideration to make is whether over the period in the last 10 years, has overally the main objective of the enactment behind the Sarbanes Oxley Act served the purpose?. The importance of auditor performance is seen in the fact that the first subchapter of the act provides for a body "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports." Whether the amended, enhanced and revised oversight structure adequately regulates public company auditors appears to be an open question even after so many years. In 2011, PCAOB Chairman James Doty stated that PCAOB inspectors had reviewed more than 2,800 engagements of the largest audit firms and "discovered and analyzed hundreds of cases involving what they determined to be audit failures." [13]An audit failure is a defined term describing the most serious deviations from proper practice. The general requirement in Sarbanes Oxley Act that all findings resulting from PCAOB inspections be held confidential hinders any analysis of perhaps the key measure of audit quality: audit failure. One of the most common problems that companies face due to internal control reporting is that they can no longer go to their auditors for advice on difficult accounting issues. This reflects strong indicator of a material control weakness if the auditor identifies a material misstatement in draft financials that the management has missed. Public reports of annual inspections of specific audit firms contain no details of findings on individual clients. This protects the firm in case of actual or

[12]Curtis C. Verschoor, *Has SARBANES OXLEY ACT been successful*, Sep 5th 2012. Available at http://www.accountingweb.com/practice/practice-excellence/has-Sarbanes Oxley Act-been-successful (Last visited on March 22,2016)

[13] Id

threatened litigation. The PCAOB has the power in removing parts of information which are confidential if it found that the upcoming improvements or changes are not upto the mark pertaining to any specific criticism.

Another problem that is faced by the corporations is that auditors have adopted a "check the box" mentality about control testing and are focusing on minutiae that could not possibly affect the financial statements. The type of controls differ from company to company i.e. small companies do not need the same type of controls as the large multinational companies. Simply put, it means that the auditor has to put a check on the controls whose purpose is to anticipate that the financial statements are materially correct.[14] Along with the responsibility of understanding the overall control system and to "walk through" the operation of all important processes, the main focus would be in material financial matters instead of trivial matters. Yet, auditors have adopted a uniform, inflexible approach.

Another very serious charge is that small companies are being burdened out of proportion because auditors are not tailoring their procedures to the client. Small companies with less complex businesses apparently need less complex controls, and the auditors should work accordingly. Also the implying costs S.404 are out of proportion and very high. There is no doubt that internal control reporting is not free. Based on the most recent survey of its members, Financial Executives International says that the expected average first-year cost is 27,000 hours of internal time for companies with an average of $5 billion in sales.[15]

Weighing the costs and benefits of a regulation that is aimed at building public confidence and protect the investors is not an easy task. The charm of the trick lies in capturing and quantifying all of the benefits. The objective of the Sarbanes-Oxley Act is to

---

[14] Christian Leuz, Peter Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*.(unpublished work). Available at http://research.chicagobooth.edu/~/media/7628D551E7424DC08524879103870C12.pdf

[15] Daniel L. Goelzer,*The costs and benefits of Sarbanes Oxley Section 404*, National Association for Business Economics 21st Annual Washington Economic Policy Conference. Available at http://pcaobus.org/News/Speech/Pages/03212005_GoelzerCostsBenefitsofSARBANES OXLEY ACT404.aspx (Last Visited on March 22,2016)

restore confidence in financial reporting. Without the investing public's confidence, our securities markets -- the engine of our national prosperity -- would cease to operate.

Another issue that Public companies face are that they are largely left without specific guidance from the Securities Exchange Commission in ascertaining the appropriate processes for establishing and maintaining disclosure controls and procedures. The SEC has stated instead that it "expects each issuer to develop a process that is consistent with its business and internal management and supervisory practices." However, this lack of specificity is understandable and probably appropriate given the wide divergence of companies subject to the new rules. Companies in different industries obviously will have different processes for collecting, processing and presenting information for disclosure purposes.[16] Perhaps the most obvious principle to be garnered from Sarbanes-Oxley, the SEC rules and the principles is that companies must identify the officers and employees who should be involved in the disclosure process and clearly define the responsibilities of such persons. The Act and the rules explicitly identify the principal executive and financial officers as the persons ultimately responsible for the company's disclosures by requiring them to certify that they have read the report and that it contains all material information and fairly presents the financial picture of the company. By requiring these officers to attest to the accuracy of the company's reports, however, the certifications also serve to encourage senior management to more actively define and police the responsibilities of those persons involved in collecting, processing and presenting information for disclosure. To be fair, a great deal of the effectiveness of Sarbanes Oxley Act depends on the vigor to which it's enforced. Questions remain as to whether the SEC's and Sarbanes Oxley Act's enforcement has been sufficient.

In responding to Sarbanes-Oxley and the rules issued there under, companies must evaluate not only the practices and policies they employ in preparing disclosure reports, but also the environment and culture underlying those practices and policies. They must ensure that employees involved in the process have the guidance and support necessary to carry out their responsibilities and that the environment in which such employees operate not just encourages, but demands the sharing of all material information—good or bad. Perhaps most

[16] Chowdhury, Shamshud D,*Why large public companies shouldn't hate Sarbanes-Oxley*, 21 IVEY BUSINESS JOURNAL ONLINE(2005). Available at- https://www.questia.com/magazine/1P3-1508349131/why-large-public-companies-shouldn-t-hate-sarbanes-oxley

importantly, companies must be vigilant that their disclosure process is open to active, critical analysis on an ongoing basis and does not become a rote, mechanical exercise of checking boxes and relying on form and procedure. Only by creating the appropriate culture will a company be able to take on the "real self-examination and learning regarding what it takes to be a corporate citizen"[i] that is at the heart of Sarbanes-Oxley. Although Sarbanes Oxley Act has been successful in increasing corporate focus on a strong ethical culture in publicly owned companies, there's room for improvement in audit firm performance as well as the PCAOB's process for assessing and reporting on it. The ultimate result of such an effective regulation and of those charged with implementing, would be seen if we succeed in maintaining the public's confidence in the integrity and transparency of those markets.

CONCLUSION

A good disclosure system supported by good governance, high quality standards and sound regulatory framework is the key to economic development of a country. Transparency and corporate disclosure is essential to investors to make proper decisions, given the extensive fluctuations in the international capital markets. The present capital market fluctuation is pushing further demands on transparent corporate-governance practices. The demand for greater levels of transparency and improved financial reporting will also lessen the fear amongst investors.[17] The stock exchange institutions around the world would increasingly become more conscious of their self-regulatory roles and scout the probability of using the listing requirements as an instrument for raising the standards of corporate governance. For supervening successful corporate performance, the issue of good corporate governance is indispensable. To achieve a good level of performance and make a company more attractive to investors, high levels of disclosure ,a responsible board of directors and a commitment to good corporate governance in terms of well-defined shareholder rights are the requisites. The corporate governance principles stresses on judicious internal control, an effective board, accountability to its shareholders and transparency. For effective management and enhancing shareholders' value corporate governance practices and procedures are essential.

---

[17] *The Financial Aspects Of Corporate Governance*, CADBURY COMMITTEE REPORT (1992) on 1 December 1992, p. 14, Para 2.5. Available at http://www.ecgi.org/codes/documents/cadbury.pdf (Last visited on March 23,2016)

All the stakeholders have a shared responsibility of building good Corporate Governance and each of them should work towards making a corporation move forward. In order to ensure effective financial reporting and supervision, it is very essential that disclosures must be accompanied by greater transparency. With greater financial transparency, companies let the investors monitor the governance process and behavior of the company, by providing them with the necessary information. However, management also needs to avoid excessive of disclosure, which may lead to impairment of competition. Transparency is one of the keys to the success of the corporate governance as it makes it possible to avoid frauds, embezzlement and other financial scandals besides fostering efficiency in allocation of resources. Transparency and disclosure most importantly differentiates the companies and allows them to compete on the basis of their best offerings. Corporate disclosure is an important matter of discussion now-a-days. The development and growth of a country's business and economy depends on financial reporting. Globalization and liberalization in the last couple of decades have led to a remarkable increase in the magnitude of business, accentuating the need for greater circumspection and clarity in business organizations, thus emphasizing the importance of corporate disclosure. Globalization and liberalization have no doubt led to unparalleled changes in the corporate world by creating unconventional means for communicating financial information to the market place. Information technology has revolutionized the way business is ransacked all over the word. The exchange of funds have been greatly swayed by the wide integration and expansion of global markets. There have been a surge in innovative financial instruments developed to deal with worldwide global economic realities and greater complex business environment. Thus, the area of financial reporting has also undergone huge changes presenting newer opportunities and challenges. In the present era, a company is considered as a socio economic entity having social and financial objectives. Genuine disclosure and transparency will deter financial scandals, treachery, theft and foster efficiency in the distribution of investments across countries and corporations. Disclosure requirements should allow firms to report separate information sets to different types of users. At present the disclosure system fails to distinguish between the very different needs of the various users of financial reporting information. While some users may be happy with lengthy disclosures, the majority are sent information that is far longer and more complex than they can make use of.

Withholding their own circumstances, each firm, sets information for most users which could be short and, beyond a minimal common core. Successful communication can result only from nominal guideline of disclosure in the common core. Whoever wants to access them, should be provided with both sets of information online. Since disclosure demands have been assembled over many years, this information overload has led to queries about relevancy and adequacy of certain information. Preparatory actions should be taken to make sure persons involved are preparing clear and understandable disclosures. Capital market participants can aid in the process by supporting disclosure of important and relevant information.[18] Carrying out well-reasoned judgment, besides, established rules and legal requirements can lead to disclosures including financial statement presentation.[19] This will also provide people with the information that is crucial for decision making. Formatting and organization can also channelize financial statements.

Transparency comes at the cost of the legitimate corporation's right to withhold their privacy, besides desire of rent seekers to hide their gains by false means. It is not an easy task to increase transparency. A corporation tries to hide its fallacies, when it is generating externalities by, for example, not revealing its financial reserves (thus jeopardizing a financial crisis that would prove detrimental to others) or secretly dumping toxic substances. Thus, one requires persistent efforts towards establishing a standard favouring transparency. By using duress or restructuring incentives, one can enforce revelations and the information thus revealed can shift power from the former holders of secrets to the newly informed. It is tough to ensure transparency and accountability through laws, rules, regulations, processes, best practices, concepts, structures, and the most progressive use of technology. Only when individuals of integrity and virtue are trying to 'do the right thing,' one can expect some changes. All in all, in the end, what matters are the actions of people, not their words.

[18]Klapper L, *Corporate Governance, Investor Protection, and Performance in Emerging Markets*, 10 JOURNAL OF CORPORATE FINANCE (2004) 703-728.

[19]Hossain Mohammed ,*The Corporate Governance Reporting Exercise: The Portrait of A Developing Country:* 7(2) INTERNATIONAL JOURNAL OF BUSINESS RESEARCH (2007) 106-118.