

**FINANCIAL REPORTING AND
CORPORATE GOVERNANCE
DISCLOSURES OF INDIAN BANKS: AN
EMPIRICAL ANALYSIS**

**Thesis submitted in accordance with the requirements of the
University of Liverpool for the degree of Doctor in Philosophy**

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Abstract

The study focuses on the financial reporting practices of Indian banking companies. Its purpose is to examine empirically, the association between a number of corporate attributes and levels of disclosure in corporate annual reports as well as to determine the quality of financial reporting. Most of the previous research in this area has concentrated on non-financial companies in both developed and developing countries, with the result that research on financial companies, and especially banking companies, is limited. India is the largest country in South Asia with a huge financial system and banks that were established according to the British pattern. Recent financial stress in East Asian economies, has urged the World Bank, and IMF to promote financial stability and greater disclosure and transparency in banking companies. Within this framework, and in order to measure more specifically, the extent of disclosure, the study covering 38 banks (68% of the sample) listed on the stock exchanges in India, has been undertaken. A total of 184 items of information comprising both mandatory (101) and voluntary (81) items have been selected, and a linear regression model has been developed in order to examine the relationship between various corporate attributes and the level of disclosure. The findings indicate that age, diversification, profitability, corporate governance, stock exchange, complexity of business and assets-in-place variables are significant, and other variables such as age, audit, dividend, are insignificant in explaining the level of disclosure. In addition, in terms of disclosure compliance, Indian banks scored as

high as 97 with an average of 88 in mandatory items, whilst in respect of voluntary items, 34 was the highest score, with an average of 25. The above findings indicate that Indian banks are very compliant with the mandatory rules and regulations, and thus will build up confidence among global investors, depositors and regulatory authorities as well as international financial institutions. On the other hand, it is found that Indian banks are far behind in disclosing voluntary items. However, the extent of overall disclosure depends on companies' attributes. This study has contributed to the academic literature highlighting the phenomenon that if there is an existence of a close monitoring system including regulatory authorities and regulations in the country, it is possible to have high compliance with disclosure legislation. This is obviously true in the case of India and the Indian banking sector. The outcome of the study will be of help to policy-makers concerned with practices associated with financial reporting in the developing countries in particular, thereby instilling confidence among global investors in the Indian financial sector.

DECLARATION

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or institution of learning.

Dated

Mohammed Hossain

Dedication

This thesis is dedicated to my parents, without whom none of this would have been even possible. It is also dedicated to **Bangabandhu Sheikh Mujibur Rahman**, Father of the Nation of **BANGLADESH** from which we gained our identity in the World Map in 1971.

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ACRONYMS AND ABBREVIATIONS

ADR	American Depository Receipts
BASEL	Basel Committee on Banking Supervision
BIS	Bank of International Settlements
BSE	Bombay Stock Exchange
CAPA	Confederation of Accountants in Pacific and Asia
CAR	Capital Adequacy Ratio
CRR	Cash Reserve Requirement
CRR	Cash Reserve Ratio
DFHI	Discount and Finance House of India Ltd.
ECB	External Commercial Borrowings
FCCB	Foreign Currency Convertible Bonds
FI	Financial Institutions
FSAP	Financial Sector Assessment Programme
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GOI	Government of India
IASC	International Accounting Standards Committee
ICAI	Institute of Chartered Accountants of India
RTPB	Report on Trend and Progress of Banking in India
ICSE	Inter-connected Stock Exchange of India Limited
ICWAI	The Institute of Cost and Works Accountants of India
IFAC	International Federation of Accountants
IDRBT	Institute for Development and Research in Banking Technology

NDS	Negotiated Dealing System
NPA	Non Performing Assets
NPL	Non Performing Loans
NRI	Non-Residents Indian
NSE	National Stock Exchange
OCB	Overseas Corporate Bodies
OTCEI	Over the Counter Exchange of India
RBI	Reserve Bank of India
ROSC	Reports on Observances of Standards and Codes
RRB	Regional Rural Bank
RTPB	Report on Trend and Progress of Banking in India
S & P	Standard and Poor
SADC	Southern Africa Development Community
SAFA	South Asian Federation of Accountants Committee
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SLR	Statutory Liquidity Ratio
STCI	Securities Trading Corporation of India Ltd.
UTI	Unit Trust of India
WPSS	Working Party on Professional Services
WTO	World Trade Organisation

CHAPTER ONE

INTRODUCTION

1.1 Introduction

The importance of financial institutions in economic development, especially the role of stock markets and banks is widely discussed in both theoretical and empirical studies¹. The key findings of these studies are that countries with better developed financial institutions tend to grow faster, and that in particular the size of the banking system and the liquidity of the stock markets, tend to have strong positive impact on economic growth (Beck and Levine, 2002; Beck *et. Al.*, 1999; Arestis *et. Al.*, 2001).

There is accumulating evidence of a relationship between financial development and economic growth. In the last two decades the link between financial intermediation (FI) and economic growth has generated a great deal of interest among academics, policy-makers and economists around the world. Several theoretical and empirical studies have addressed the potential links between financial development and economic growth. Indeed, many economists have extensively investigated the relationship between finance and growth, and have found that financial development has a strong, positive impact on economic growth (see Levine, 1997).

In order to demonstrate the link between financial structure and economic growth, it is important to briefly explain how financial systems affect growth. A primary function of financial systems (financial markets and intermediaries) is to move funds

¹ See Levine (2003) for a survey of the literature.

from people who save, to people who have productive investment opportunities. This primary function can be separated into three basic sub- functions: the mobilisation of savings, the acquisition of information, and the management of risk (Dolar and Meh, 2002). By fulfilling these functions, financial systems improve both the quantity and quality of real investments and thereby increase income per capita, and raise the standard of living.

There are three major channels through which the financial system can promote growth (Pagano, 1993; Levine, 1997). Firstly, the provision of financial services can encourage the mobilisation of savings from many disparate savers. Financial systems affect growth by improving the efficiency with which those savings are used and increasing the amount of funds allocated to firms, thus facilitating the growth of capital and productivity. That is, financial systems can raise firm investment by reducing liquidity risk and idiosyncratic risk. Moreover, by mitigating risk (particularly liquidity risk), financial systems positively influence economic growth, since they eliminate the premature liquidation of firm capital (Dolar and Meh, 2002).

Secondly, better screening and monitoring of borrowers can lead to more efficient resource allocation. For instance, well-developed stock markets enhance corporate control by: (i) aligning the interests of managers with those of firm owners, and (ii) facilitating takeovers to mitigate the principal-agent problem and so encourage economic growth (Dolar and Meh, 2002). Furthermore, financial intermediaries can promote growth by economising on the costs of gathering information by replacing many monitors with one delegated monitor.

Thirdly, improvements in risk-sharing can enhance savings rates and promote innovative, high-quality projects. For example, stock markets reduce liquidity risk by allowing agents who receive liquidity shocks to readily and cheaply sell their shares in firms. Similarly, financial intermediaries, particularly banks, mitigate liquidity risk by issuing demand deposits and by pooling the savings of individuals (Dolar and Meh, 2002).

Indeed, financial development (that is, the development of well-functioning financial markets and intermediaries), has a positive impact on long-run economic growth. This conclusion is supported by the cross-country studies, firm-level analyses, industry-level estimations, and time-series approaches surveyed by Levine (1997).

This chapter goes on to describe the importance of the financial system, especially in developing countries like India, and explains how the financial system affects Indian economic growth.

1.2 The Role of Financial Systems

Financial systems channel household savings to the corporate sector and allocate investment funds among firms. They allow inter-temporal smoothing of consumption by households and expenditures by firms, permitting both firms and households to share risks. These channels are the sources connecting financial development and financial structure to economic growth (Allen and Oura, 2004).

Economists have long been interested in the role of financial development in resource allocation, and the hypothesis that financial development facilitates the

efficient allocation of resources dates back to at least Schumpeter (1912), who conjectured that banks identify entrepreneurs with good growth prospects, and therefore, help to reallocate resources to their most productive uses. More recently, Levine (1997) has described a number of channels through which financial development may affect allocative efficiency, including those concerned with information generation, risk-sharing, financing, and monitoring.

In practice, two views prevail on the importance of the financial system during development (Lucas, 1988). The first is that the financial sector does not matter very much, and that any correlation between financial development and growth is a result of growth leading development. Robert Lucas, in his celebrated 1988 paper on development said:

“ ... in general, I believe that the importance of financial matters is very badly over-stressed in popular and even much more professional discussion and so am not inclined to be apologetic for going to the other extreme.” (Lucas, 1988, p.37)

The second view is that an efficient financial system is the key to development. In his classic, *Lombard Street*, published in 1873, Walter Bagehot argued that it was England's efficient capital markets that made the industrial revolution possible. However, the most important and thorough early contribution on financial development and economic development, came from Joseph Schumpeter, whose 1912 German book on the subject was published in English only in 1934, as *The Theory of Economic Development*.

Schumpeter (1912) contended that financial development causes economic development, that financial markets promote economic growth by funding

entrepreneurs, and in particular by directing capital to those entrepreneurs with high returning projects. He developed his case in vivid language:

“The banker ... is not so much primarily a middleman in the commodity ‘purchasing power’ as a producer of this commodity... He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development, though only when no central authority directs the social process. He makes possible the carrying out of new combinations, authoresses people, in the name of society as it were, to form them. He is the ephod [overseer] of the exchange economy”.

It can, therefore, be strongly argued that financial systems affect long-run economic growth. However, the specific organisation of the financial system and structure (the mixture of financial markets and intermediaries) matters for growth, and hence, there is a need to explore associated issues. In particular, it is a necessary to investigate whether a market-based financial system is more growth-promoting than an intermediary-based system (and vice versa), or whether it is the combination of both types of system that most affects long-run growth. To help provide an answer this study seeks to explain how the quality of financial information disclosed by financial intermediaries to markets both varies and is determined. This will help in understanding how markets (i) aid the savings mobilisation process, (ii) evaluate investment opportunities and exert corporate control, and (iii) facilitate risk management. In other words, I focus on how, and how well, financial intermediaries provide information to markets. The focus is primarily upon the Indian financial sector.

1.2.1 Savings Mobilisation and Allocation

Financial intermediaries boost the mobilisation of savings in at least two ways (Dolar and Meh, 2002). Firstly, they lower transaction costs associated with collecting savings from numerous individuals in the economy, and secondly, they mitigate the moral hazard and adverse selection problems that make individuals less willing to relinquish control of their savings. By alleviating the asymmetric information problems and by reducing transaction costs, financial intermediaries ease savings mobilisation, and thereby increase economic growth. The channels through which financial intermediaries encourage long-run growth, are as follows: (i) by mobilising savings, they increase capital formation, which in turn increases the national savings rate, and (ii) by exploiting economies of scale, thus reducing transaction costs per unit of transaction as the size of a transaction increases, financial intermediaries improve the allocation of savings.

1.2.2 Information Acquisition

When borrowers have private information about the quality of their projects *ex ante*, screening by the intermediary is essential to provide agents with incentives to accurately report whether the project is bad or good. Without screening, 'bad' borrowers may pretend to be 'good', and this may lead to under-investment in good projects, since lenders cannot observe the true type of borrowers (adverse selection). Indeed, screening has played a major part in developing theories of credit rationing (Stiglitz and Weiss, 1981). Because it is costly to screen projects, it is optimal to delegate the acquisition of information to intermediaries to avoid the duplication of costly information acquisition (Boyd and Prescott, 1986).

Financial intermediaries can mitigate the free-rider problem in the private production of information (Dolar and Meh, 2002, p. 17). The free-rider problem emerges when individuals who do not pay for information, take advantage of the information that other individuals have paid for. A direct consequence of the free-rider problem is that it prevents the private market from producing enough information to eliminate the asymmetric information that leads to adverse selection and moral hazard.

Financial intermediaries, particularly banks, can avoid the free-rider problem by making primarily private loans rather than purchasing securities that are traded in the open market. Because private loans are not traded, no one can free-ride on the intermediary that is monitoring and screening projects. As a result, financial intermediaries have greater incentives to acquire the costly information.

By reducing free-riding, financial intermediaries improve the ex ante assessment of investment opportunities (screening), and the ex post exertion of corporate control once those investments have been funded (and so address the principal-agent problem). This, in turn, improves capital allocation and boosts economic growth (Dolar and Meh, 2002).

1.2.3 Risk Sharing

One of the most important functions of a financial system is to achieve an optimal allocation of risk. Many studies have directly analysed the interaction of the risk-sharing role of financial systems and economic growth (Diamond and Dybvig, 1983; Helpman and Razin, 1978; Levine, 1991). These theoretical analyses clarify the conditions under which financial development facilitates risk sharing, and promotes

economic growth and welfare, but in most such studies, researchers focus on either markets or intermediaries, or a comparison of the two extreme cases where all financing is conducted by either markets or intermediaries. The intermediate case in which markets and institutions co-exist, is rarely analysed in the context of growth models, because the addition of markets can destroy the risk-sharing opportunities provided by intermediaries (Allen and Oura, 2004).

One important impact of risk sharing on economic growth lies in the fact that while savers generally do not like risk, high-return projects tend to be riskier than low-return projects. Thus, financial markets that ease risk diversification tend to induce a portfolio shift toward projects with higher expected returns, as pointed out by Greenwood and Jovanovic (1990), Saint-Paul (1992), Devereux and Smith (1994), and Obstfeld (1994). Moreover, King and Levine (1993a) showed that cross-sectional risk diversification could stimulate risky innovative activity for sufficiently risk-averse agents. The ability to hold a diversified portfolio of innovative projects reduces risk and promotes investment in growth-enhancing innovative activities.

1.2.4 Empirical Evidence

The vast majority of the empirical literature on the relationship between financial intermediation and economic growth has concentrated on domestic aspects. In other words, it has been concerned with intermediation where the lenders, borrowers, and the intermediating parties are all residents of a single nation, and where the asset-liability relationships are assumed to be denominated exclusively in the national currency unit.

In addition, the aim of most recent empirical studies has been to determine whether there is a significant causal link running from financial development to economic growth, and in this respect numerous researchers have applied different econometric methods to explore the correlation between financial development and growth. The pioneering studies, including the work of Goldsmith (1969), have adopted cross-country growth regression analysis. A trend within the empirical literature is to examine the relationships in a number of countries using either cross-section or panel data techniques (Jung, 1986; Roubini and Sala-i-Martin, 1992; Demetriades and Hussein, 1996; and Luintel and Khan, 1999). Another trend is to examine the issue for a particular country using time series techniques, for example, Odedokun (1989) for Nigeria, Lyons and Murinde (1994) for Ghana, Murinde and Eng (1994) for Singapore, Agung and Ford (1998) for Indonesia, and Wood (1993) for Barbados.

Goldsmith (1969), using data from 35 countries between 1860 and 1963, examined the correlation between financial intermediation and economic growth, concluding that “a rough parallelism can be observed between economic and financial development if periods of several decades are considered” (p.12). Similarly, McKinnon (1973) and Shaw (1973) reported a close association between financial development and economic growth in a number of countries. King and Levine (1993b) conducted a study with 77 countries for the time period of 1960–89, finding a strong positive relationship between financial development and growth, and identifying certain indicators for growth regression.

Levine (1997) provides a comprehensive review of the pre-1997 literature, concluding that:

“The preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth. A growing body of work would push even most sceptics toward the belief that the development of financial markets and institutions is a critical and inextricable part of the growth process and away from the view that the financial system is an inconsequential side show, responding passively to economic growth and industrialization. There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change” (Levine, 1997, pp. 688-689).

From this statement one would almost be tempted to conclude that the debate on the relationship between financial development and economic growth has been laid to rest.

However, evidence from developing countries is very limited. An attempt to examine the role of Southern Africa’s financial intermediation in an economic union was made by Allen and Ndikumana (1998). Using four indicators of financial intermediation and three different panel techniques – simple OLS regressions; regressions including country-specific fixed effects; and regressions including a high-income dummy, they found a positive correlation between financial development and the growth of real per capita Gross Domestic Product (GDP) for the Southern Africa Development Community.

To summarise, the currently-available empirical studies show that (1) there is a strong positive effect from finance to growth, and (2) the result seems to be able to survive the issue of causality and robustness of results against inclusion of omitted variables that capture the economies’ characteristics.

1.3 India's Financial System

The Indian financial system is characterised by a large network of both foreign and domestic banks, a well-developed stock market, and financial institutions (Bery, 1996, p. 245). Indeed India as the largest country in South Asia has a huge financial system characterised by many and varied financial institutions and instruments and its banking sector was well developed even prior to its political independence in 1947. After nationalisation of the major commercial banks in late 1969, the system expanded rapidly and “now ranks in the top quarter among developing countries” (Khanna, 1995, p. 265).

The strength of Indian banks is remarkable in terms of their position in the global top ranking of 1,000 banks. According to ‘The Banker 2004’, out of the top 1,000 banks globally, over 200 are located in USA, just above 100 are in Japan, over 80 are in Germany, over 40 are in Spain, and around 40 are in the UK. Even China has as many as 16 banks within the top 1,000. However, India had 20 banks within the top 1,000, which is perhaps reflective of differences in the size of economies and of financial sectors. Commercial banks hold around two-thirds of the total assets of the Indian banks and other financial institutions taken together. In addition, the share of banking assets in the total Indian financial sector assets was around 70% as of March 2007 (RBI, 2007). The securities market constitutes a critical component of Indian financial markets. Presently, there are 23 stock exchanges in the country with a total market capitalisation of US\$770 billion at end of 2007. Corporate sector and governments together raised a total of Rs. 226,911 billion from the securities market during 2001-02, and there are about 40 million investors who have invested in securities. India recorded one of the highest growth rates in the world in 2003-04,

being second only to China among the emerging market economies. This robust economic performance was particularly noteworthy in an environment marked by hesitant global recovery, heightening of geo-political tensions during the year, volatility in international crude oil prices, and large asset price movements in international financial markets engendered by abundant liquidity. Domestic developments – largely immune to the global business cycle – powered a surge in real GDP growth to 8.2% – the highest in 15 years (RBI, Annual Report, 2003-04). Growth in the Indian economy has steadily increased since 1979, averaging 5.7% per year in the 23-year growth record (Economic Survey, 2004-05).

As of 30th June 2007, the total number of public sector, private sector and foreign banks in India were respectively 28, 30 and 42 (RBI, Annual Report 2007). At the top of the banking system is the Reserve Bank of India (RBI), which is responsible for the prudential supervision of banks, and non-banks, and for performing other central banking functions. There have been two successive nationalisations² of banks in India, one in 1969 and the other in 1980, and in consequence, public sector banks occupy a predominant role in the Indian financial system (Sathye, 2001). Despite a phenomenal expansion in the number of branches, the population served per branch stood at 15,000 (RBI Bulletin, 2004), due to the fact that country's population has been growing unabated (surpassing the one billion mark recently), and branch networks cannot keep pace with demand due to the costs involved. In the year 1997-98, the aggregate deposits of the public sector banks were of the order of Rs. 5,317 billion (51% of GDP), those of private sector commercial banks were Rs. 695 billion (7% of GDP), and the foreign banks held Rs. 429 billion (4% of GDP). The advances

² The detail of nationalisation is discussed in Chapter Three.

were Rs. 2599 billion (25% of GDP), Rs. 354 billion (3% of GDP), and Rs. 292 billion (3% of GDP) respectively (Sathye, 2001). The public sector banks control over 80% of all banking business. Over the years, the banking system has developed well in terms of its geographical coverage, deposit mobilisation and credit expansion. From the late 1960s, Indian banking was subjected to tighter governmental control over ownership, known as social control over banks: the government nationalised the banks later. As part of these reforms, the banks were subjected to directed credit, prescribed interest rates and substantial pre-emption of deposits, and those banking services that had previously been mostly confined to metropolitan areas, were expanded to the rural areas. Thus, while at the end of 1964 only 10% of the commercial banks were located in rural areas, the proportion increased to 45% thirty years later. The share of advances to activities in the priority sector³ increased substantially after nationalisation, and currently, the overall priority sector credit target is 40% of net bank credit for both public sector and private sector banks, with the foreign bank target being 32%. The share of priority sector advances in the total credit of commercial banks increased from 14% in 1969 to 30% in 1980 and to 39% in 1985 (Thakur, 1990).

Since the early 1990s, the Government of India has implemented many banking sector reforms⁴. These include lowering of the cash reserve ratio from 15% (1993-94) to the present 8.5% (July 2000), lowering of the statutory liquidity ratio from 38.5% (1992-93) to 28.2% (1995-96), a gradual deregulation of interest rates on deposits and lending, and the introduction of prudential norms in line with

³ Priority sector refers to the lending for agriculture and other rural sectors of the economy, poverty alleviation programmes, exports, small-scale industries and such other purposes.

⁴ The details of bank reform are discussed in Chapter Three.

international standards. A system of flexible exchange rates on current accounts has been adopted. The Committee on the Financial System, appointed by the Government of India in 1991, identified directed investment and credit programmes as the two main sources of declining efficiency, productivity and profitability among commercial banks. Consequently, the percentage of priority sector advances dropped to 37% (1998) and the percentage of rural branches in the total network has declined to 42%. These and other similar policy initiatives, indicate the desire to make Indian banking more competitive by establishing a level playing field among the three groups of banks. India's economic policy reforms have played a critical role in the performance of the national economy since 1991. Among other things, they have involved opening the economy, making it more competitive, getting the government out of the huge morass of regulation, empowering the states to take more responsibility for economic management, and thereby creating a kind of competition between the states for foreign investors (Bajpai and Sachs, 2000).

Although many financial institutions and markets in India are moving towards world standards with increasingly sophisticated processes (including risk management tools and the extensive use of Information Technology (IT)), they have also concomitantly been exposed to a very different risk profile. In this new operating environment, there remain features that are incompatible with the processes and systems critical for both efficient functioning and commercial viability. This is especially true of the banking sector, where, despite progress in terms of prudential norms, risk management, and reductions in levels of non-performing assets (NPAs), systemic weaknesses still remain obdurately entrenched (Gaur and Sharma, 2002).

The Reserve Bank of India has initiated a host of measures for the creation of a competitive environment and improved efficiency in the process of financial intermediation. Indian regulations have been assessed by the Reserve Bank's Standing Committee on International Financial Standards and Codes (Chairman: Dr. Y.V. Reddy), against the benchmark of international best practices, in order to facilitate positioning of international financial standards and codes in relevant areas of the country's financial system, and to guide the overall process of implementation of appropriate changes in respect of various segments of the financial system. India is one of the countries that have sought participation in the joint IMF-World Bank Financial Sector Assessment Programme (FSAP). As part of the Reports on Observances of Standards and Codes (ROSCs), India's compliance in respect of standards and codes has already been evaluated in respect of six codes, viz., Monetary and Financial Policy Transparency, Fiscal Transparency, Banking Supervision, Securities Market Regulation, Payment and Settlement System, and Corporate Governance. Currently, assessment is being undertaken with regard to Special Data Dissemination Standards.

1.4 Rationale for the Study

The financial information of a firm is communicated to the market through a variety of channels, and the market participants subsequently interpret that information and use it to make various assessments, for example, the share price, the cost of capital, and future earnings estimates. Firms that generate a large quantity of relevant, reliable information enable market participants to form more accurate assessments, and can thus be considered transparent. Conversely, firms with vague, inaccurate, or

sparse information will inhibit market assessments. These firms are considered opaque (Ang and Ciccone, 2002) and some banks can fall into this category.

As mentioned earlier, the Indian economy has emerged as one of the fastest growing emerging market economies and the Indian banking sector is perceived as being the best performer in Asia. The Reserve Bank of India (RBI), on its part, continues to ensure financial stability, strengthening of prudential norms with the strategy of convergence of international best practice, consistent with the specific national needs, and progressive strengthening of the supervisory framework. Accordingly, the focus of policy initiatives would be on streamlining banking operations in order to reduce transaction costs, infusing flexibility into the system, upgrading risk management systems, enhancing the level of compliance by banks with accounting standards, operationalising consolidated accounting practices, and last and most important of all, providing the public with a financial system they can trust.

One of the primary objectives of the banking sector deregulation in India is to introduce an element of market discipline into the regulatory process. However, for the market's disciplining mechanism to operate, banks must provide transparent disclosures of their operations and risks in a timely fashion, and they must adopt prudent accounting policies. Although a costly endeavour for a bank, transparency can generate significant benefits at the firm-specific level. Previous empirical research has demonstrated that firms that provide a higher quality of disclosure benefit by way of improved market liquidity and reduced cost of capital, primarily because of the reduction in the level of information asymmetry among investors (Chipalkatti, 2002. Such transparency in bank disclosures (a) enables investors to

more accurately assess a bank's financial strengths and performance; (b) increases the credibility of the information disclosed by the bank; (c) demonstrates the risk-management ability of the bank by disclosing relevant information about the quality and quantity of risks it faces and (d) reduces market uncertainty associated with its cash flow stream. Better quality public disclosures reduce the level of information asymmetry between bank managers and investors and thereby enhance investor confidence in a bank's stock and in the banking industry (Chipalkatti, 2002). In addition, empirical research has demonstrated that high quality disclosures improve a firm's market liquidity (Welker, 1995) and reduce its cost of capital (Botosan, 1997).

The role of transparency and disclosure of information in effective market discipline and effective banking supervision is discussed in the 1988 Basel Committee on Banking Supervision (BASEL) report "Enhancing Bank Transparency". Specifically, the report recommends that banks make meaningful disclosure in six broad areas: financial performance; financial position (including capital, solvency and liquidity); risk management strategies and practices; risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks); accounting policies; and basic business, management and corporate governance information. The report recommends that banks publicly disclose such information to foster market discipline and strengthen financial stability by promoting transparency of banks' activities and risk exposures. Further, it encourages supervisors to have access to this, and other information of supervisory interest.

In the Indian context, it can be observed that there is a substantial market of financial institutions, a sound security market, an efficient regulatory environment and

evidence of two successful reform initiatives in the banking sector, as well as tightened supervision. It is obviously desirable to have a sound, effective, transparent and effective market discipline. As the current study focuses on Indian banks' reporting practices, it will seek to make a substantial contribution to knowledge regarding the present pattern, practices, and the gaps in disclosing information in annual reports. In broad terms, the study's outcomes will assist policy-makers concerned with practices of financial reporting of Indian banks, and may indicate how to improve the confidence of global investors in the Indian financial sector.

1.5 The Objectives of the Study

The overall purpose of the current study is to examine the financial reporting practices of Indian banks, and in order to achieve this overall aim, the following specific objectives have been established:

- i. To describe the nature and structure of the financial sector in India;
- ii. To analyse the regulatory and financial environment of the Indian banking sector both in relation to banks and other financial institutions *per se* and to corporate disclosures by banks and to place regulation in its broader, external context;
- iii. To highlight the stages of development of the banking sector and its impact on the economy;
- iv. To elaborate a literature review in relation to banking disclosure and transparency;
- v. To establish hypotheses in order to assess the corporate attributes which explain the variation in the extent and quality of overall financial reporting of Indian banking companies and of corporate governance items;

- vi. To collect data on Indian banks' overall disclosures of financial information and of corporate governance items and to assess levels of disclosure and the causes of variation in disclosure levels between banks against those hypotheses;
- vii. To analyse the results of the study's hypothesis testing and to draw conclusions, and recommendations and policy implications based on findings of the research.

CHAPTER TWO

THE INSTITUTIONAL FRAMEWORK AND REGULATORY ENVIRONMENT FOR THE INDIAN FINANCIAL SECTOR

2.1 Introduction

One of the major areas of the economy that has received renewed focus in recent times has been the financial sector. And within the broad ambit of the financial sector, it is the banking sector that has been a main subject of interest for academics and policy-makers alike. With concerns about financial stability emerging to the forefront of policy challenges facing central banks worldwide, it is being increasingly realised that promoting healthy financial institutions, especially banks, is a crucial pre-requisite towards this end. Not surprisingly therefore, the banking sector in most emerging economies is passing through challenging, yet exciting, times and India is no exception to this rule (Bhide *et al.*, 2001).

This chapter has been organised as follows: Section 2.2 deals with the overview of the Indian Banking Sector; Section 2.3 gives attention to the structure of the Banking sector; Section 2.4 describes the structure of Indian capital markets; Section 2.5 refers to the environment of financial reporting in India; and Section 2.6 provides a general regulatory and institutional characteristics of accounting bodies in India; Section 2.7 gives a conclusion.

2.2 An Overview of the Indian Banking Sector

Banks in India were established on the British pattern at the beginning of the 19th century. In those days, all the banks were joint stock banks and a large number of them were small and weak. At the time of the Second World War, about 1,500 joint stock banks were operating in undivided India, out of which over 1,400 were non-scheduled banks. A substantial number were considered to be managed by bad and dishonest management, and naturally there were bank failures. Hence, the Government had to introduce legislation and the Banking Companies Act, 1949 was enacted (which was subsequently renamed the Banking Regulation Act), which led to gradual elimination of weak banks that were not in a position to fulfil the various requirements of the Act. In other words, the experience of post-war bank failures in India and its consequent unsettling effect on the banking structure, culminated in the passing of the Banking Companies Act 1949 for regulating and guiding banks in the country, and put the banking industry on a sound footing. The passing of this legislation is considered as a milestone in India's banking history. In order to strengthen the weak units and revive public confidence in the banking system, a new section (Section 45) was inserted within the Banking Regulation Act 1949 in September 1960, empowering the Government of India to compulsorily amalgamate weak units with stronger ones on the recommendation of the Reserve Bank of India (hereafter RBI). The RBI, founded in 1935 and nationalised in 1949, is India's principal banking institution and the Central Bank of India.

As at 30th June 2004, there were 320 scheduled banks in India having a total network of 66,218 branches. The scheduled commercial banks in India comprise of the State Bank of India and its associates, nationalised banks, foreign banks, private sector

banks, State co-operative banks, and regional rural banks (RBI, Annual Report – 2000). In addition, there are 23 recognised stock exchanges in India, including the Over the Counter Exchange of India (OTCEI)⁵ for small and new companies, and the National Stock Exchange (hence after NSE), which was established as a model exchange to provide nation-wide services to investors. Among them, the Bombay Stock Exchange (hereafter BSE) is India's second largest stock exchange and the oldest stock exchange in Asia. Moreover, the Indian capital market ranks top in terms of the number of stock exchanges, the second on the basis of listed companies in the world, the third largest nation in respect of share holding population, and the fourth in terms of capitalisation (Ajay and Thomas, 2001). It may be cited that with over 20 million shareholders, India has the third largest investor base in the world after the USA and Japan. Over 9,000 companies are listed on the stock exchanges, which are serviced by approximately 7,500 stockbrokers. The Indian capital market is significant in terms of the degree of development, volume of trading and its tremendous growth potential (Ajay and Thomas, 2001).

Steady improvements in laws relating to rules-based governance, which India inherited from the British, have been introduced to keep pace with the changes demanded by liberalisation policies. Currently, the quality of financial and non-financial disclosures, mandated by law, is stronger in India than in most developing countries and a number of developed European countries (Monga, 2004).

⁵ The OTC Exchange of India (OTCEI) incorporated under the provisions of the Companies Act 1956, is a public limited company. It allows listing of small and medium-sized companies. The minimum issued share capital required of a company that wants to be listed on the OTCEI is Rs.3 million and the maximum is Rs.250 million.

The financial reporting and disclosure of banking companies in India are regulated by the Companies Act 1956, the Banking Regulation Act 1949, the rules of the Securities and Exchange Commission of India (hereafter SEBI), and the guidelines of RBI as well as the recommendations of the Institute of Chartered Accountants of India (hereafter ICAI). Thus, all incorporated and listed companies' quality of financial disclosure in the annual accounts is determined by three agencies, these being:

- i. The Department of Company Affairs, which administers the Companies Act 1956.
- ii. The SEBI, which mandates special disclosure requirements for listed companies.
- iii. The ICAI, the body which stipulates the parameters of Indian accounting standards (Goswami, 2003).

In addition, the RBI as a banking regulator provides guidelines and recommendations to the banking companies in order to enhance the standard of reporting and transparency as well as to establish sound market discipline.

All companies have to submit their statutorily audited annual accounts first to the audit committee of their board of directors for discussion and approval. The Audit committee then recommends the results to the full board for assent. Thereafter, the annual accounts are sent to all shareholders, and their adoption is sought in the

annual shareholders' meeting. Copies of the accounts are then lodged with the Registrar of Companies. Listed companies have three other requirements. Firstly, the annual accounts have to be submitted to every stock exchange where the companies are listed. Secondly, the companies have to prepare abridged un-audited financial summaries for every quarter. Thirdly, in addition to all the disclosure requirements mandated under the Companies Act 1956 for public limited companies, listed firms have to submit a detailed cash flow statement (Goswami, 2003).

It can be observed from the above discussions that India has an organised financial market and a good regulatory environment. The purpose of the remainder of this chapter is to elaborate that regulatory environment and the institutional framework of the Indian banking sector in particular.

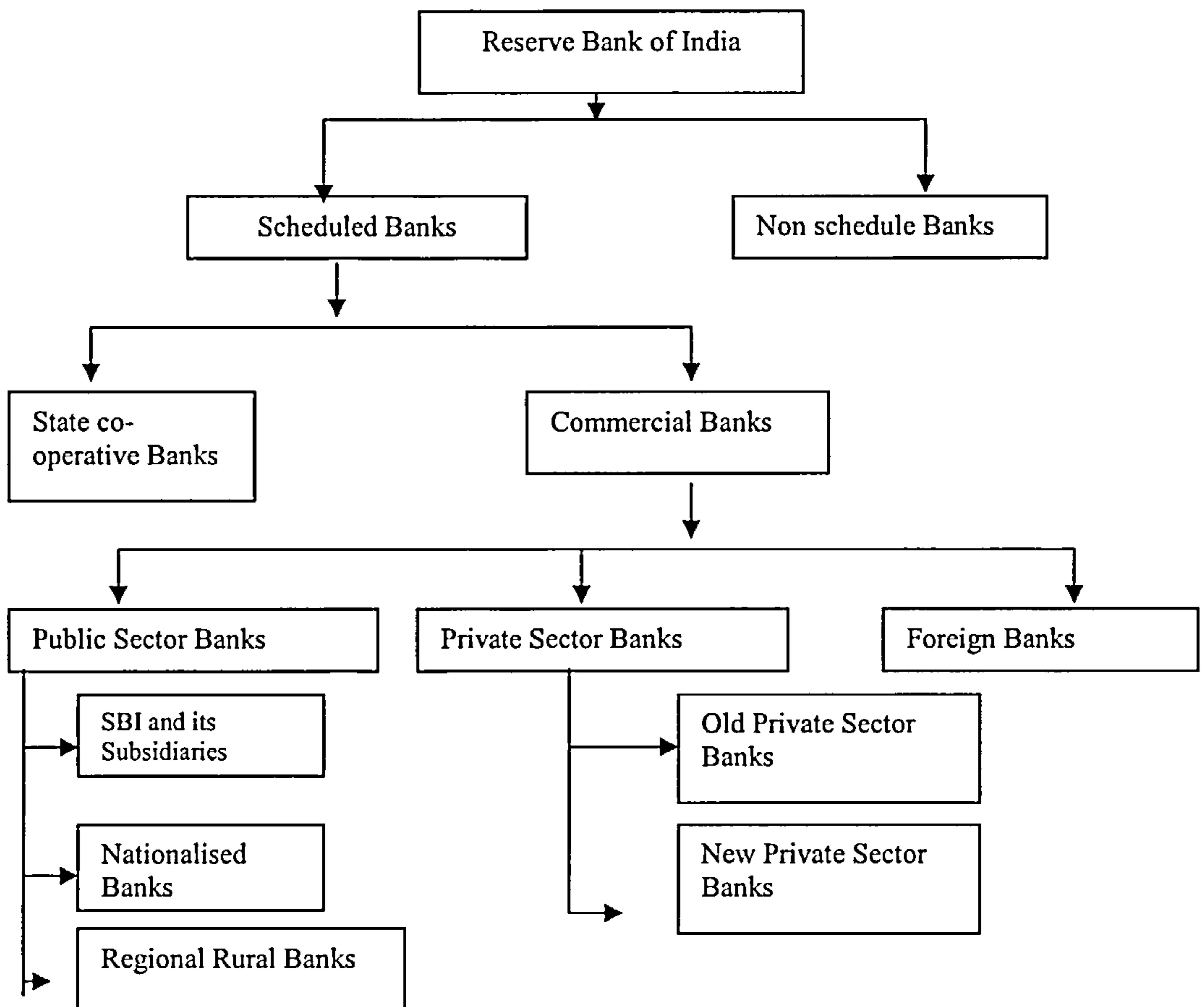
2.3 The Structure of the Banking Sector and Relevant Issues

The banks in India have quite heterogeneous characteristics and different regulatory treatment. In other words, the Indian financial system is characterised by a large network of commercial banks, financial institutions, stock exchanges, and a wide range of financial instruments (Agarwal, 2000). Indeed, there is a significant presence of both foreign and domestic banks and a well-developed stock market (Bery, 1996, p. 245). The system expanded rapidly after the nationalisation of major commercial banks in late 1969 and "now ranks in the top quarter among developing countries" (Khanna, 1995, p. 265). The Indian banking sector consists of the RBI, which is the central bank, commercial banks and co-operative banks. Commercial banks are of two types i.e., scheduled and non-scheduled. Scheduled banks can be further classified into public sector banks (comprising the State Bank of India and its

seven associates, nationalised banks and the regional rural banks); private sector banks, which include old and new banks, and finally, foreign banks.

The structure of the banking sector is depicted in Figure 1.

Figure 1: Structure of the Indian Banking Sector



In addition, many foreign banks maintain branch offices in India and Indian banks also maintain offices in numerous foreign countries. As at 31st March, 2004, there were 95 branches on Indian banks spread over 25 countries and located in major

international centres like London, Singapore, Amsterdam, Bahrain, New York, Hong Kong, Tokyo, Frankfurt, and Paris.

There are now 58 banks operating in India, 27 belonging to the public sector, 23 to the old private sector, and 8 to the new private sector. Although there are now 36 foreign banks in India, a study by Bhaumik and Piesse (2004) has shown that the 12 largest account for nearly 90% of the deposit and asset base of this group.

From the above discussion, it can be understood that the banking system in India, like that in most developing economies, is characterised by the co-existence of different ownership groups, public and private, and within private, domestic and foreign banks. Public sector banks in India came into existence in several phases. In 1955, the Government of India (GOI) took over the ownership of the Imperial Bank of India and reconstituted it as the State Bank of India (hereafter SBI) under the State Bank of India Act of 1955. Later, in 1959, the State Bank of India (Subsidiary Banks) Act was passed, enabling the SBI to take over seven banks of the princely states as its associate banks. The SBI and its associates were entrusted with the task of serving the banking needs of the hitherto neglected sectors. However, notwithstanding the progress made by these banks in terms of geographical coverage and credit expansion, it was felt that commercial bank credit was loaned mainly to the large and well-established business houses, and sectors such as agriculture and small scale industries were being neglected. Thus in 1967, the policy of social control over banks was announced and in 1969, 14 of the largest private banks were nationalised under the Nationalisation Act of 1969. A second phase of bank nationalisation followed with six more private banks being nationalised in 1980. The

smaller private banks as well as the foreign banks were allowed to co-exist with the public sector banks, but their activities were highly restricted through entry regulation and strict branch licensing policies (Kumbhakar and Sarker, 2004).

With the nationalisation of the major commercial banks a large number of regulatory measures were adopted by the RBI. Apart from changing the sectoral composition of credit, the RBI stipulated lending targets to priority sectors, provided refinancing facilities, set up credit guarantee schemes, and directed banks to open branches in rural and semi-urban areas to make banking accessible to all. The RBI also fixed maximum deposit rates on both savings and time deposits of all maturities, and specified differential lending rates linked to borrowers' income and types of lending. The Lead Bank scheme was started for designing and implementing credit plans at the micro level. These measures led to the phenomenal growth of the banking system in general, and the public sector banks in particular. By the early 1990s, public sector banks accounted for nearly 90% of total deposits and advances, with the residual being almost equally split between private and foreign banks. (Kumbhakar and Sarker, 2004). However, by this time, the excessive focus on quantitative achievements had made many of the public sector banks unprofitable and under-capitalised by international standards. Many banks were earning less than reasonable rates of return, had low capital adequacy and high volumes of non-performing assets, and were providing poor quality customer service. Operating costs were increasing at a very high rate and the rapid growth in staff numbers and promotions had diluted the quality of manpower.

In recognition of these growing problems, and according to the recommendations of the First Narasimham Committee on Financial Sector Reforms, the RBI launched major banking sector reforms in 1991 aimed at creating a more profitable, efficient and sound banking system. The reforms sought to improve bank efficiency through entry deregulation, branch de-licensing, deregulation of interest rates, and mandating strong public sector banks to go to the capital market to raise funds up to 49% of their equity capital. The last move was primarily targeted at generating market pressures on good public sector banks so that they became more efficient. The reforms also aimed to improve bank profitability through the gradual reduction of the Cash Reserve Ratio and the Statutory Liquidity Ratio, and to strengthen the banking system through the institution of the Bank of International Settlements (BIS) norm of an 8% Capital Adequacy Ratio, as well as stringent income recognition and provisioning norms⁶. These changes were intended to create a competitive environment that, in the long-run, was expected to lead to substantial gains in efficiency, profitability, and productivity (Kumbhakar and Sarker, 2004).

In order to understand the nature and formation of these banks I will now discuss the structure set out in Figure 1 above.

2.3.1 The Reserve Bank of India (RBI)

The RBI was established under the Reserve Bank of India Act 1934 on 1 April, 1935, and nationalised on 1st January, 1949. It is the sole authority for the issue of currency in India other than one rupee coins and subsidiary coins and notes, and acts as banker to the Central Government, state governments, commercial banks, state co-operative

⁶ See Sarkar (1999) for an exhaustive review of the recent banking sector reforms

banks and some of the financial institutions. It formulates and administers monetary policy with a view to ensuring stability in prices while promoting higher production in the real sector through proper deployment of credit. The RBI plays an important role in maintaining the stability of the exchange value of the rupee, and acts as an agent of the Government in respect of India's membership of the International Monetary Fund. Additionally, it performs a variety of developmental and promotional functions. These functions apart, the RBI also handles the borrowing programme of the Government of India (GOI).

2.3.2 Scheduled Banks

These are those banks which are included in the Second Schedule of the Reserve Bank Act 1934, and falling into this category if they satisfy the criteria laid down in Section 42 (60 of the Act). Scheduled banks can be divided into two groups i.e. State Co-operative Banks and Commercial Banks. Some, but not all, co-operative banks come under the category of scheduled banks. The scheduled banks in India under the commercial banks category comprise the SBI and its associates (8); Nationalised Banks (19), Regional Rural Banks (hereafter RRB), Old and New Private Banks, and Foreign Banks.

2.3.3 Non-Scheduled Banks

These are those joint stock banks, which are not included in the second schedule of the RBI Act on account of their failure to comply with the minimum requirements for being scheduled. In other words, a non-scheduled bank is a banking company as defined in Clause I of Section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank.

2.3.4 Commercial Banks

These are those banks that operate banking business under the Banking Companies Act 1956, and include public, private and foreign banks in India. Public Sector banks are those in which the GOI or the RBI is a majority shareholder. These banks include the SBI and its subsidiaries, Nationalised Banks and the RRB.

2.3.5 The State Bank of India and its Subsidiaries

The SBI is the oldest and largest commercial bank in India, with its presence covering all time zones in the world. In the mid-19th century, the East India Company established three banks, i.e. the Bank of Bengal in 1809, the Bank of Bombay in 1840, and the bank of Madras in 1843. These three banks, which were independent units and called Presidency banks, were amalgamated in 1920 to form the Imperial Bank of India. After Independence, the Imperial Bank of India was nationalised and renamed the State Bank of India in consequence of the State Bank of India Act 1955. In 1955, another State Bank of India (Subsidiary Banks) Act was passed, creating seven subsidiaries of the State Bank of India. The SBI has maintained its lead as India's premier commercial bank, and the driving force behind rural development, industrial diversification and technological upgrading in India. This group is comprised of the State Bank of India (SBI) and its seven subsidiaries viz., State Bank of Patiala, State Bank of Hyderabad, State Bank of Travancore, State Bank of Bikaner and Jaipur, State Bank of Mysore, State Bank of Saurashtra, and State Bank of Indore. The RBI owns the majority share of the SBI and some associates banks of the SBI.

2.3.6 Nationalised Banks

In 1969, the government arranged the nationalisation of 14 scheduled commercial banks in order to expand the branch network, and followed this strategy by nationalising six more in 1980. Nationalised banks were wholly-owned by the Government, although some of them have since made public issues.

2.3.7 Regional Rural Banks

The RRBs had been established to take the banking services to the doorsteps of the rural masses, especially in remote rural areas with no access to banking facilities. Originally, they were intended to provide institutional credit at concessional interest rates, to those weaker sections of society, who had previously been dependant on private money-lenders. The banks were also intended to mobilise and channel rural savings to support productive activities in the rural areas. However, with effect from 22 March 1997, the RRBs were allowed to lend outside the target group, by classifying their advances into 'Priority Sector' and 'others'. They were established to operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs.

2.3.8 Private Sector Banks

These are essentially comprised of both old established and the new. The old private sector banks are those which were operating before the Banking Nationalisation Act was passed in 1969, whilst the new private sector banks were established when the Banking Regulation Act was amended in 1993.

2.3.8.1 Old Private Sector Banks

This group consists of banks that were established by the princely states, community organisations or by a group of professionals, for the cause of economic betterment in their area of operations. Initially, their operations were concentrated in a few regional areas, but their branches slowly spread throughout the nation as they grew.

2.3.8.2 New Private Sector Banks

These banks were started as profit-oriented companies after the RBI opened the banking sector to the Private sector. These banks are mostly technology-driven and better managed than other banks.

2.3.9 Foreign Banks

These are banks that were registered outside India and have originated in a foreign country. Foreign Banks entered the Indian market in 1993, and as at the end of March, 2004, a total of 33 foreign banks were present in India, having total assets of Rs 1,36,315 crore (Rs 1363.15 billion), and accounting for about 7% of the total banking space. The list of foreign players includes banks such as Citibank, Bank of America, Bank of Nova Scotia, ABN-AMRO Bank, Deutsche Bank and J P Morgan Chase Bank, which figure in the top 25 global banks ranked by *The Banker* magazine. Other major international banks such as Credit Suisse Group, and Industrial and Commercial Bank of China have yet to commence their banking business in India.

2.4 Structure of Indian Capital Markets

The origination of the Indian securities market may be traced back to 1875, when 22 enterprising brokers established the Bombay Stock Exchange (BSE) under a Banyan tree. Over the last 125 years, the Indian securities market has evolved continuously to become one of the most dynamic, modern and efficient securities markets in Asia. Today, Indian markets conform to international standards, both in terms of structure and in terms of operating efficiency (Vengayill, 2003).

Capital markets in India comprise equity, debt, foreign exchange and derivatives markets, including futures markets in commodities. These markets are key components of the financial sector because of their transparency in disseminating price information. Markets help in the discovery of the price of assets and the price of risk in the economy. They help to shape the behaviour of owners of capital in making decisions about which firms and industries to allocate scarce capital to. The major stock exchanges are the Bombay Stock Exchange (now called The Stock Exchange, Mumbai or the BSE) and the National Stock Exchange. The stock exchanges, other securities markets, and markets for primary issues are regulated by the Securities and Exchange Board of India. Since 1991, there has been significant development in the capital markets both directionally and dimensionally. The Indian capital market has now become one of the leading capital markets among developing countries, and is highly responsive to world developments. Debt instruments, bonds, government securities and mutual funds have emerged as important parts of the capital markets. Foreign Institutional Investors (FIIs) have become one of the most important players in Indian capital markets, major FIIs continuing to be bullish on investment in India. Small investors are also becoming an important part of the

market and regulations have been introduced by the Securities and Exchange Board of India to protect small investor interests. The emergence of credit rating agencies and the growing importance and acceptance of credit rating is another important development. Indian markets have completely adopted 'dematerialisation' of securities and are engaged in futures trading in securities.

Following the implementation of reforms in the securities industry during the last decade, Indian stock markets have graduated to a better position vis-à-vis the securities markets in other developed and emerging markets. As may be seen from Table 2.1, India has a turnover ratio, which is comparable to the other developed markets, and is also one of the highest in the emerging markets. At the end of 2003, Standard and Poor (S&P) ranked India 17th in terms of market capitalisation (19th in 2002), 16th in terms of total value traded in stock exchanges (17th in 2002), and 6th in terms of turnover ratio (7th in 2002). India has the number one ranking in terms of number of listed securities on the exchanges followed by the USA (NSE, 2004). These data, though quite impressive, do not reflect the full Indian market, as S&P (and even other international publications) does not cover the whole market. For example, India had more than 9,000 listed companies at the end of March 2004, while S&P considers only 5,644 companies. If the whole market were taken into consideration, India's position vis-à-vis other countries would be much better (NSE, 2004).

Table 2.1 International Comparison of Stock Exchange Statistics: 2003

	USA	UK	Japan	Germany	Singapore	Hong Kong	China	India
Number of listed Companies	5,295	2,311	3,116	684	475	1,029	1,296	5,644
Market Capitalisation (S Bn.)	14,266	2,412	3,041	1,079	145	715	681	279
Market Capitalisation Ratio (%)	139.8	159.7	70.3	57.5	168.4	426.4	55.2	56.4
Turnover (S Mn.)	15,547	2,151	2,273	1,147	88	332	477	285
Turnover Ratio (%)	122.8	100.6	88.0	130.0	71.1	56.3	477	138.5

Source: Standard & Poor's Emerging Stock Market Fact Book, 2004

2.4.1 The Securities and Exchange Board of India (SEBI)

The SEBI has been established under an Act of Parliament (Act 15 of 1992) to promote the development of, and to regulate, the securities markets, as well as to protect the interests of investors in securities. The functions entrusted to the Board under the Act are wide ranging and include the following: the protection of the interest of investors, the promotion and development as well as regulation of securities markets, such as regulating the business in stock exchanges and other securities markets, registering and regulating the working of stock brokers and intermediaries associated with the securities markets, registering and regulating the working of depositories, FIIs and other intermediaries, and registering and regulating the work of venture capital funds, including mutual funds, as well as prohibiting

fraudulent and unfair trade practices and insider trading in securities and acquisition and takeover of companies.

Up to 1992, the primary capital market was controlled by the Controller of Capital Issue (CCI) formed under the Capital Issues Control Act. During that period, the pricing of capital issues was controlled by the CCI. The premium on the issue of equity shares through the primary markets was established in accordance with the Capital Issues Control Act. With the establishment of the Securities and Exchange Board of India (SEBI) the CCI guidelines were abolished. The SEBI was formed to promote fair dealing in the issue of securities and to ensure that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and the investors.

2.4.2 Status of Stock Exchanges in India

There are 23 exchanges in India, which offer screen-based trading systems, connected using the Very Small Aperture Terminals (VSAT) technology from over 357 cities. At the end of March 2004, there were 9,368 trading members registered with SEBI (SEBI Annual Report, 2004). The names of the 23 stock exchanges and their locations are as follows:

- 1) The Stock Exchange, Ahmedabad
- 2) Bangalore Stock Exchange Ltd., Bangalore
- 3) Vadodara Stock Exchange Ltd., Baroda
- 4) Bhubaneswar S. E. Assoc. Ltd., Bhubaneswar
- 5) Calcutta Stock Exchange Association Ltd., Calcutta

- 6) Madras Stock Exchange Ltd., Madras
- 7) Cochin Stock Exchange Ltd., Kerala
- 8) Coimbatore Stock Exchange Ltd., Tamil Nadu
- 9) Gauhati Stock Exchange Ltd., Gauhati
- 10) Hyderabad Stock Exchange Ltd.,
- 11) Madhya Pradesh Stock Exchange Ltd., Indore
- 12) Jaipur Stock Exchange Ltd., Jaipur
- 13) Uttar Pradesh Exchange Association Ltd., Kanpur
- 14) Ludhiana Stock Exchange Association Ltd., Ludhiana
- 15) The Stock Exchange, Mumbai
- 16) Mangalore Stock Exchange Ltd., Mangalore
- 17) Delhi Stock Exchange Association Ltd., Delhi
- 18) OTC Exchange of India, Mumbai
- 19) Magadh Stock Exchange Association, Patna
- 20) Pune Stock Exchange Ltd., Pune
- 21) Saurashtra-Kutch Stock Exchange Ltd., Rajkot
- 22) National Stock Exchange, Mumbai
- 23) Inter-connected Stock Exchange of India Ltd., Mumbai

From the above list four stock exchanges have been selected for particular discussion to illustrate the Indian stock exchanges' current activities and practices, these exchanges being the stock exchange at Mumbai, the National Stock Exchange, the Over the Counter Exchange of India, and the Inter-connected Stock Exchange of India Limited, each of which is now considered in turn.

2.4.2.1 The Stock Exchange, Mumbai

Popularly known as the BSE, the Stock Exchange, Mumbai, was established in 1875 as The Native Share and Stock Brokers Association. It is the oldest stock exchange in Asia, even older than the Tokyo Stock Exchange, which was established in 1878. It is a voluntary non-profit making Association of Persons (AOP) and completed the process of converting itself into a demutualised and corporate entity in May 2007. As a consequence at least 51% of the equity in the BSE itself will be publicly held rather than being held by trading members. Over the years, it has evolved into its present status as the country's premier Stock Exchange, being the first to have obtained permanent recognition in 1956 from the Government of India under the Securities Contracts (Regulation) Act, 1956 (www.bseindia.com). While providing an efficient and transparent market for trading in securities, debt and derivatives, the Exchange upholds the interests of the investors and ensures the redress of their grievances, whether against companies issuing securities or its own member-brokers. It also strives to educate and enlighten the investors by conducting investor education programmes and making available to them necessary informative inputs. There are 4,833 companies listed on the BSE with a total market capitalisation (May 2007 unless otherwise stated) of Rs 4,077,452 crore (\$US 99.12 billion). The Stock Exchange, Mumbai is the most active stock market in India, counting for over 70% of the listed capital and 90% of market capitalisation. Hence, it is the premier national stock exchange. The BSE accounted for 46% of listed companies on an all-India basis, ranking first in terms of the number of listed companies and stock issues listed and accounting for over 50% of the overall capital listed on all the stock exchanges. Its share of the market capitalisation was around 74%. The paid-up capital of equity, debentures/bonds and preference shares, were 73%, 31%, and 44%

respectively of the overall capital listed on all the stock exchanges. The average number of daily trades on the exchange is over one million, giving it one of the highest per hour rates of trading world-wide.

2.4.2.2 The National Stock Exchange

The National Stock Exchange (NSE), located in Bombay, is India's first debt market. It was set up in 1993 to encourage stock exchange reform through system modernisation and competition, and opened for trading in mid-1994. The instruments traded are treasury bills, government securities, and bonds issued by public sector companies as well as a range of financial derivatives. As at May 2007, the number of companies listed on the NSE was 1,262, having a market capitalisation of Rs. 3,650,368 crore. The NSE is India's leading stock exchange by geographic spread, covering 364 cities and towns across the country. It was established by leading financial institutions to provide a modern, fully automated screen-based trading system with national reach, and has brought about unparalleled transparency, speed and efficiency, safety and market integrity.

2.4.2.3 The Over the Counter Exchange of India

The Over the Counter Exchange of India (OTCEI) has been promoted by leading financial institutions of India. It was established in 1990 with the objective of providing a window to small companies (which would have otherwise lacked resources) to approach the large capital markets for funds to meet their capital requirements. The OTCEI seeks to address the needs of small investors by providing them with easy access, better liquidity, quick settlements and transparency. The

minimum issued share capital for a company seeking listing is Rs 3m and the maximum Rs 250m.

2.4.2.4 Inter-Connected Stock Exchange of India Limited

The Inter-connected Stock Exchange of India Limited (ISE) has been promoted by 14 regional stock exchanges to provide cost-effective trading linkage and connectivity to all the members of the participating exchanges, with the objective of widening the market for the securities listed on these exchanges and consolidating the small, fragmented, and less liquid markets into a national liquid market. The ISE is a national-level stock exchange that provides trading, clearing, settlement, risk management and surveillance support to its traders and dealers. It aims to address the needs of small companies and retail investors with the guiding principle of optimising the existing infrastructure and harnessing the potential of regional markets, so as to transform these into a liquid and vibrant market through the use of state-of-the-art technology and networking. The participating exchanges have around 4,500 brokers with 450 dealers across 70 cities.

2.5 Environment of Financial Reporting in India

Indian corporate financial reporting requirements and regulatory structures are based, as in the UK and similar countries, on the interaction of law, self-regulation by the accountancy profession, and regulation of listed companies through stock exchange rules. Thus, financial reporting requirements are chiefly based on the Companies Act 1956, on regulations of the Company Law Board, on accounting standards issued by the Institute of Chartered Accountants of India (ICAI), and in addition for listed companies, the rules, regulations and releases issued by the

Securities and Exchange Board of India. March year ends are the most common for Indian companies. An amendment to the Companies Act 1956 in October 1998 requires compliance with accounting standards established by a National Advisory Committee (NAC) on Accounting Standards. Accounting standards specified by the Institute of Chartered Accountants of India must be followed until the NAC has addressed the issue. The ICAI's Accounting Standards Board's policy is to take International Accounting Standards into consideration in developing its standards. As noted already, and in common with practice in many other countries, additional financial reporting rules and other regulations apply to Indian banks.

2.5.1 Banking Regulation Act 1949

The title of the Banking Companies Act, 1949 was changed to the Banking Regulation Act 1949, by the amending Act of 1965 (Act No.23 of 1965). The Act represents the first regulatory step taken by the Government to streamline the functioning and activities of commercial banks in India. The Reserve Bank of India, as the Central Banking Authority of the country, was vested with extensive powers for banking supervision. The Banking Regulation Act enacted in 1949 provides a framework for regulation and supervision of commercial banking activity, in addition to, and not in derogation of, the Companies Act, 1956 (1 of 1956), and any other law currently in force. However the provisions of the Companies Act apply only to the banks in the private sector.

Section 29(1) of The Banking Regulation Act 1949 states that at the expiration of each calendar year, every banking company must prepare a balance-sheet and profit

and loss account, in the forms set out in the Third Schedule (Form A) and Form B of the Act, respectively.

Section 30(1) states that the balance sheet and profit and loss account prepared in accordance with Section 29, must be audited by a person duly qualified under law.

Section 31(1) also states that the accounts and balance-sheet together with auditor's report must be published in the prescribed manner and furnished in three copies as returns to the Reserve Bank of India (RBI) within three months from the end of period.

Section 32 requires that three copies of the accounts and balance-sheet, together with the auditor's report, be sent to the Registrar of Company Affairs.

In addition, banks also have to follow the rules and guidelines issued by the RBI and SEBI. The accounting practices followed in India are as per the Accounting Standards set by the Institute of Chartered Accountants of India (ICAI). Companies are required to follow disclosure norms set under the Companies Act and SEBI guidelines relating to listed entities. Both in respect of Accounting Practices and disclosures, banks in India are guided by the Reserve Bank of India guidelines issued from time to time, which are, by and large, in line with the Accounting Standards of ICAI and other regulatory bodies. It is pertinent to note that the ICAI Accounting Standards are based on International Accounting Standards (IAS) being followed in a large number of countries.

2.5.2 Reserve Bank of India (RBI) Guidelines

The RBI is committed to enhancing and increasing the levels of transparency and disclosure in banks' annual accounts, and it mandates banks to disclose additional information as part of their annual financial statements, as follows:

1. **Capital Adequacy Ratio:** In India banks are institutions where depositors place their savings on the assumption that the risk shall be borne by the bank. In such a scenario, the banks must have enough capital to meet unforeseen contingencies so that the confidence of the depositors is not shaken. The CAR is equal to TIER-I and TIER-II capital to the Aggregate of Risk Weighted Assets.
2. **Tier I ratio:** This refers to the core capital that provides the most permanent and ready support against unexpected losses. Tier I capital consists of the following components:
 - a. Paid-up Equity Capital
 - b. Statutory Reserves
 - c. Other Undisclosed Reserves
3. **Tier II ratio:** The components of this are as follows:
 - a. Undisclosed reserves and cumulative perpetual preference shares
 - b. Revaluation Reserves
 - c. General Provisions and loss reserves
 - d. Hybrid Debt Capital Instruments
 - e. Subordinated Debt
4. Percentage of shareholding of the Government of India in nationalised banks;

5. Net Non-Performing Loans ratio;
6. Amount of provision made towards Non-Performing Loans and provisions for income-tax for the year;
7. Amount of subordinated debt raised as Tier II capital;
8. Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India;
9. Interest income as percentage of working funds;
10. Non-interest income as a percentage of working funds;
11. Operating profit as a percentage of working funds;
12. Return on assets; business (deposits and advances) per employee
13. Profit per employee;
14. Maturity pattern of certain assets and liabilities;
15. Movement in Non-Performing Loans;
16. Foreign currency assets and liabilities;

These 16 items are mandatory for banks to disclose in the annual reports as part of their additional information.

2.5.3 The Securities and Exchange Board of India (SEBI)

The SEBI monitors and regulates the corporate governance of listed companies in India through Clause 49, which is incorporated in the listing agreement of stock exchanges with companies, and requires compliance with its provisions. Under Clause 49, a separate section on Corporate Governance is required in the Annual Reports of companies, together with a detailed compliance report on Corporate

Governance. Non-compliance of any mandatory requirement of this clause has to be addressed and reasons provided, and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The details of items to be included in the 'Corporate Governance Report' appear in Appendix-2. It is also noted that the company must obtain a certificate from either the auditors or practising company secretaries regarding compliance with the conditions of corporate governance as stipulated in this clause, and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate must also be sent to the Stock Exchanges along with the annual report filed by the company.

The listing requirements with the stock exchange call for further disclosure by companies to promote public confidence. Important disclosures are:

- The company is required to furnish unaudited half-yearly financial results in the prescribed *proforma*.
- The company must explain to the Stock Exchange any large variation between audited and unaudited results in respect of any item.
- When any person or an institution acquires or agrees to acquire any security of a company which would result in his holding 5% or more of the voting capital of the company, including the existing holding, the Exchange must be notified within two days of such acquisition by the company or by authorised intermediary or by the acquirer.
- Any take-over offer made either voluntarily or compulsorily to a company requires a public announcement by both the offeror and the offeree company.

2.6 General Regulatory and Institutional Characteristics

Indian corporate financial reporting requirements and regulatory structures are based, as in the UK and similar countries, on the interaction of law, self-regulation by the accountancy profession, and regulation of listed companies through stock exchange rules. Thus, financial reporting requirements are chiefly based on the Companies Act 1956, on regulations of the Company Law Board, on accounting standards issued by the Institute of Chartered Accountants of India (ICAI), and in addition for listed companies, the rules, regulations and releases issued by the Securities and Exchange Board of India. March year ends are the most common for Indian companies. An amendment to the Companies Act 1956 in October 1998 requires compliance with accounting standards established by a National Advisory Committee (NAC) on Accounting Standards. Accounting standards specified by the Institute of Chartered Accountants of India must be followed until the NAC has addressed the issue. The ICAI's Accounting Standards Board's policy is to take International Accounting Standards into consideration in developing its standards. As noted already, and in common with practice in many other countries, additional financial reporting rules and other regulations apply to Indian banks.

2.6.1 Professional Accountancy Bodies

Two professional accountancy bodies are active in India, these being:

- i. The Institute of Chartered Accountants of India (ICAI)
- ii. The Institute of Cost and Works Accountants of India (ICWAI)

A brief discussion of each now follows in order to provide a comprehensive understanding of these organisations and their roles in the Indian economy.

2.6.1.1 The Institute of Chartered Accountants of India

The Institute of Chartered Accountants of India was established on 1 July, 1949 by The Chartered Accountants Act 1949, for the purpose of regulating the profession of Chartered Accountant in India. The affairs of the Institute and the functions assigned to it, are managed and discharged by a Council comprising 24 members elected by the members of the Institute all over the country, and six persons nominated by the GOI. Besides the Central Council, there are five Regional Councils, one each located at Mumbai, Chennai, Calcutta, Kanpur and New Delhi. These apart, there are 87 branches of Regional Councils located in various parts of the country. The headquarters of the Institute are at New Delhi and five Regional Offices exist at Mumbai, Chennai, Calcutta, Kanpur and New Delhi. The Institute also has nine Chapters outside the country in Abu Dhabi, Bahrain, Doha, Dubai, Jeddah, Muscat, Zambia, Botswana and Saudi Arabia (Eastern Province). The total membership of the Institute is about 90,000, of which about 70% are practitioners. Among the members in government, industry, banks, financial institutions, private enterprises etc. a significant number of members occupy eminent positions in their respective organisations such as Chairmen of regulatory bodies, Chairmen of banks, Chairmen and Managing Directors of reputed enterprises, and Executive Directors of innumerable enterprises and organisations.

2.6.1.1.1 Professional Activities

The Institute is a founder member of various international professional bodies such as the International Federation of Accountants (IFAC), the Confederation of Accountants in Pacific and Asia (CAPA), and the South Asian Federation of Accountants (SAFA), and the international accounting standards committees (the

International Accounting Standards Committee, IASC as was, now the International Accounting Standards Board, IASB).

Increasingly, the ICAI is playing a proactive role in international affairs and has drawn up a definite strategy with the ultimate aim of exporting professional services in a substantial manner. The aim is to enable Indian accountancy professionals to engage in international business and other activities in competition with their counterparts from developed countries.

The first step in this direction was the signing of a Memorandum of Understanding on 26th April, 1998, with the newly-formed Institute of Chartered Accountants of Nepal, whereby the ICAI provides technical and other support for the growth of the profession in Nepal. Similar Memoranda of Understanding have also been signed with the Ukrainian Federation of Professional Accountants and Auditors, The Chamber of Audit of the Kyrgyz Republic, and the Russian Board of Auditors.

Additionally, the Institute has entered into a reciprocal agreement with the accountancy bodies of Italy in respect of technical support for the development of professionals.

The ICAI's Continuing Professional Education Directorate is charged with the responsibility of providing continuing professional education to members of the Institute. In addition, this directorate prepares background material for the seminars organised in various parts of the country and also organises seminars of professional importance and relevance. It also takes responsibility for the activities related to

Postgraduate Examinations. There are three postgraduate courses organised by the Institute, these being. Corporate Management, Management Accountancy, and Tax Planning and Tax Management, and only members of the Institute are eligible to join these. The CPE also holds teleconferencing programmes on topics of current interest in order to reach its members and students in all parts of the country.

2.6.1.1.2 Functions

As part of its role in aiding the pro-active process towards better governance, the Institute is called upon to interact with various regulatory and statutory authorities in India on issues of interest touching upon the accountancy profession and otherwise. The Institute, on its part, is putting the vast experience of its structure and its members at the disposal of those charged with governance. In this process, the Institute provides technical advice at regular intervals, to various regulatory bodies such as the Comptroller and Auditor General of India, the Department of Company Affairs of the Government of India, which deals with all matters relating to Corporate Laws in India, the RBI and the Securities and Exchange Board of India, the Central Board of Direct Taxes, the apex body for direct tax matters, and the Insurance Regulatory Authority.

Hence, it adopts an active role in providing necessary inputs in respect of the following:

- i. To the Comptroller and Auditor General of India, by providing technical advice on matters of audit panels and questions issues arising out of the audit and accounts of government companies and public sector undertakings.

ii. To the Department of Company Affairs, by providing inputs in regard to matters relating to corporate laws and responses to technical issues.

iii. To the Reserve Bank of India, by providing technical advice in regard to matters pertaining to bank audits and the audit of non-banking financial companies, and general systems issues (as with preparations for Y2K).

iv. To the Securities and Exchange Board of India, by providing advice and comment on accounting.

Following the initiative taken by the Institute, more Departments of the Central and State Governments of the country are approaching it with a view to utilise the services of chartered accountants for advice on economy accounting issues, development of control mechanisms over public funds, and the optimum and effective use of funds. In addition, the Institute also provides necessary inputs, from time to time, to the Trade Policy Division, Ministry of Commerce of the GOI, so as to enable the Indian government to participate more effectively in negotiations with the Working Party on Professional Services (WPSS) of the World Trade Organisations (WTO).

2.6.1.1.3 Responsibility for Accounting Standards Setting

The responsibility for developing accounting standards in India falls upon the ICAI. Accounting standards in India have generally been modelled on those of the United Kingdom, but they are very different from those that prevail in the United Kingdom today. The Accounting Standard Board of ICAI conducts research and develops accounting standards taking into consideration related laws, the business environment, business practices, and other reasonable factors that would affect a true and fair view of corporate financial reporting. Financial reporting rules are issued as

accounting standards, which are themselves divided into two categories: mandatory rules and recommendations. The 29 Indian accounting standards (ASs) currently in issue appear in Appendix 1.

As noted, the ICAI's standards board is committed to considering international accounting standards in formulating ASs. To date, 29 International Accounting Standards (both IASs and International Financial reporting Standards, IFRSs) have been adopted in India and a further seven standards, including IAS 30 Disclosures in Financial Statements of Banks and Similar Financial Institutions, are under consideration. In early 2006 the then Prime Minister of India announced that the GOI would introduce comprehensive new company legislation that would contain provisions aligning Indian accounting standards with IFRSs. The new law would replace the existing 50-year-old company law with the objective of promoting greater transparency and efficient governance. Consequently, the ICAI set up a task force in October 2006 to explore the possibility of adopting all IFRSs in full, without modification, as Indian standards. The 11-member task force was chaired by S. C. Vasudeva, chairman of ICAI's Accounting Standard Board. It will develop a concept paper on adoption of IFRSs in India. Currently, many ICAI standards reflect modifications of IFRSs. A discussion of some important differences between Indian accounting standards and IFRS is given in Chapter 7.

2.6.2 The Institute of Cost and Management Accountants of India (ICMAI)

The Institute of Cost and Management Accountants of India was founded in 1944 as the Institute of Cost and Works Accountants of India and was registered as a company under the Companies Act with the objectives of promoting, regulating, and

developing the profession of cost accountancy. It is the only recognised statutory professional organisation and licensing body in India specialising exclusively in cost and management accountancy. The Institute was given statutory recognition and its members' professional status by a special act of Parliament in 1959. The Standing Committee of the Parliament on Finance submitted a report on a proposed Institute of Cost and Works Accountants of India (Amendment) Bill 2003 in February 2005 which recommended a change of nomenclature to The Institute of Cost and Management Accountants of India.

The main objectives of the Institute are

- (a) To develop the Cost and Management Accountancy function as a powerful tool of management control in all spheres of economic activities;
- (b) To promote and develop the adoption of scientific methods in cost and management accountancy;
- (c) To develop the professional body of members and equip them fully to discharge their functions and fulfil the objectives of the Institute in the context of the developing economy;
- (d) To keep abreast of the latest developments in cost and management accounting principles and practices, and to incorporate such changes that are essential for sustained vitality of the industry and other economic activities;
- (e) To exercise supervision over entrants to the profession and to ensure strict adherence to the best ethical standards by the profession;

(f) To organise seminars and conferences on subjects of professional interest in different parts of the country for the cross-fertilisation of ideas for professional growth;

(g) To carry out research and publication activities covering various economic spheres and the publishing of books and booklets for spreading information of professional interest to members in industrial, education and commercial units in India and abroad.

2.7 Conclusion

From the above discussion and analysis, it may argue that India has a mature structure for its banking sector and a developing and strong capital market with sound and efficient institutional and regulatory environment with strong supervision and monitoring networks. India has been closely associated with various standard setting bodies in both financial reporting and banking and has been taking an active part in the work of several key international forums devoted to the task of developing and promoting the implementation of financial standards and codes. Moreover, Reserve Bank of India officials have worked closely with the Basel Committee on Banking Supervision (BCBS). In 1997, in consultation with the supervisory authorities of some non-G-10 countries including India, the BCBS drew up the 25 '*Core Principles for Effective Banking Supervision*' aimed at guiding supervisory authorities seeking to strengthen their current supervisory regime. The disclosure of information in the annual reports is closely guided by the RBI and SEBI. The new norms of RBI and Clause 49 of SEBI have introduced a new dimension in the Indian banking sector and have been providing signals designed to reach a high standard of transparency and disclosure in bank reporting.

CHAPTER THREE

BANKING SECTOR REFORM AND EXTERNAL REGULATORY INFLUENCES ON INDIAN BANKING

3.1 Introduction

Strengthening financial systems is one of the central issues facing emerging markets and developing economies (Shirai, 2002). This is because sound financial systems serve as an important channel for achieving economic growth through the mobilisation of financial savings, putting them to productive use, and transforming various risks (Beck *et al.*, 1999; King and Levin, 1993a; Rajan and Zingales, 1998; and Jayaratne and Strahan, 1996). In this context, many countries adopted a series of financial sector liberalisation measures in the late 1980s and early 1990s, which included interest rate liberalisation, entry deregulation, reduction of reserve requirements, and removal of credit allocation. For example, during the 1980s and early 1990s, several Asian economies deregulated their banking systems by transferring the vast majority of banking assets to the private sector, reducing interest rate ceilings on loans and deposits, partially liberalising short-term capital flows, reducing reserve requirements and controls on bank assets, and permitting banks to engage in a greater range of activities, e.g. investment banking (Arun and Turner, 2002b). In India, since 1991, structural reforms have been undertaken in many sectors simultaneously with an aim to enhance productivity, efficiency and international competitiveness of the economy, but the most effective of the reforms have been those in the financial sector. The main thrust of financial sector reforms has been the creation of efficient and stable financial institutions and the development of markets, especially money and government securities (Singh, 2005).

In the Report on Currency and Finance 2001-02 of the RBI, some major characteristics of the financial system in India during the pre-reform period and the rationale for reformation were mentioned as follows:

“Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channelling resources from the surplus to deficit sectors ... Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. This apart from inhibiting the development of the markets also affected their efficiency. The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of the banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential norms and the supervisory system. In the banking sector, the particular focus was on imparting operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring financial soundness”. (RBI, 2003, Report on Currency and Finance 2001-02, Chapter VI.)

Indeed, the underlying philosophy was to make the banking system more market-oriented and to that end, engendered a shift in the role of the RBI from the micro-management of banks' operations to macro governance.

With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced. These had the effect of switching emphasis in regulation more from government agencies to the discipline of the market, placing, *inter alia* greater importance on corporate governance in the

reformed institutions.⁷ This chapter is an attempt to evaluate the process of banking sector reform and the consequences, in order to understand the variations of economy in general, and India's banking sector in particular.

The chapter is organised as follows: Section 3.2 describes a brief overview of the Indian banking sector reform process; Section 3.3 reports the pre-formed position of banking and finance in India; Section 3.4 highlights the features of the first phase of financial sector reforms; Section 3.5 expresses the characteristics of the second phase of financial sector reforms; Section 3.6 depicts the consequences of the reform; Section 3.7 offers External Regulatory influences on Indian banking; Section 3.8 analyses the recommendation of Basel committee of banking supervision and Section 9 provides the role of the US financial accounting standard board; Section 3.10 gives the role of the international accounting standard committee and Section 3.11 offer a conclusion.

3.2 An Overview of the Banking Sector Reform Process

India pursued a heavily regulated inward-oriented development strategy after its independence, with the change in the policy perspective not emerging until the end of the 1980s, when partial economic deregulation measures were adopted to promote industry and trade. Simultaneously, an expansionary fiscal policy was also pursued to support industrialisation. This policy mix contributed to the building up of excessive demand on the macro-economic front, while distortions across the sectors remained rigid and substantial. Given these underlying conditions, the fragility of the economy became apparent when a series of negative external events, such as the rise in oil

⁷ A theme taken up in this thesis by a focus on patterns and determinants of corporate governance disclosures by Indian banks on corporate governance (see Chapter Ten below).

prices, loss of remittance income resulting from the Gulf War, and a reduction in exports to the former Soviet Union, hit the country. The consequence was an unprecedented crisis with the country's foreign reserves totalling an equivalent of only two weeks of imports by July 1991. Supported by the International Monetary Fund (IMF), World Bank and the Asian Development Bank (ADB), the GOI swiftly adopted a stabilisation programme and introduced wide-ranging structural reforms. An integral part of all these was financial sector reform (ADB, Programme Performance Audit Report, 1999). Against this background, in 1991, structural reforms were undertaken in many sectors, including the financial sector, simultaneous with aims to enhance productivity, efficiency and international competitiveness of the economy, but the most effective of the reforms have been those in the financial sector. Indeed, the main objectives of the financial sector reforms have been (1) modifications in the policy framework, (2) improvement in financial health and competitive capabilities of entities, (3) building financial infrastructure, and (4) upgrading the level of managerial competence and the quality of human resources (Rangarajan, 1998, p. 552).

3.3 Banking and Finance in the Pre-reform Period

It is noted that in the 1970s and 1980s, the banking industry in India was marked by a high degree of regulation. The banks functioned in a heavily regulated and controlled environment, with an administered interest rate structure, quantitative restrictions on credit flows, high reserve requirements, and pre-emption of a significant proportion of loadable resources towards the priority sectors. These regulations resulted in a significant reduction in bank managements' autonomy in asset deployment, credit rationing, low asset quality, and low levels of investment

and growth. Furthermore, productivity and efficiency declined, with profitability remaining sluggish. As certain rigidities and weaknesses were found in the system, the GOI felt that these had to be addressed to enable the financial system to play its role in ushering in a more efficient and competitive economy.

Moreover, until 1991, the government owned the majority of the extensive banking sector in India which consisted of commercial banks, co-operative banks (both rural and urban) and regional rural banks. The commercial banking sector composed largely of public sector banks, has grown at a fast pace, particularly since 1969 when 14 banks were nationalised (banks with deposits of Rs.500 million or more). A further six banks (banks with deposits exceeding Rs.20 billion) were nationalised in 1980 (Arun and Turner, 2002a). However, it is noted that the establishment of new privately-owned banks had been stopped from 1969 onwards.

In the period 1969-1991, the number of banks was increased slightly but savings were still successfully mobilised, in part because relatively low inflation kept negative real interest rates at an acceptable level, and in part because the number of branches was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound, owing to their poor lending strategy and lack of internal risk management under government ownership (Shirai and Rajasekaran, 1991). Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15%, while capital and reserves averaged about 1.5% of total assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks' true performance. The major factors that contributed to deteriorating bank performance included (a) too

stringent regulatory requirements (i.e., a cash reserve requirement [CRR]⁸ and statutory liquidity requirement [SLR] that required banks to hold a certain amount of government and eligible securities); (b) low interest rates charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition (Shirai and Rajasekaran, 2002). These factors not only reduced incentives to operate properly, but also undermined regulators' incentives to prevent banks from taking risks via incentive-compatible prudential regulations, and protect depositors with a well-designed deposit insurance system. In essence, the multiplicity of regulations and political interference in the management of banks and other financial institutions, diluted the mechanism of credit allocation and managerial accountability, and weakened the banks' financial viability (Ahluwalia, 1999).

Against this background, the GOI established a nine-member committee on financial systems, under the chairmanship of Mr. N. Narasimham (henceforth Narasimham Committee) in July 1991 to evaluate the systemic banking problems, in what was basically the first phase of financial sector reforms. The Narasimham Committee report published towards the end of 1991, contained far-reaching recommendations for the banking sector. The detailed recommendations and framework of the Narasimham Committee are now discussed.

⁸ The CRR requires banks to hold a certain portion of deposits in the form of cash balances with the Reserve Bank of India. In the 1960s and 1970s, the CRR was 5%, but then rose steadily to its legal upper limit of 15% in early 1991. The statutory liquidity requirement requires banks to hold a certain amount of deposits in the form of government and other approved securities. It was 25% in 1970 and then increased to 38.5% in 1991 – nearly to the level of its legal upper limit of 40%. With respect to direct lending, the priority sector target of 33% of total advances was introduced in 1974, and the ratio was gradually raised to 40% in 1985. There were sub-targets for agriculture, small farmers, and disadvantaged sections.

3.4 The First Phase of Financial Sector Reforms

The foundation for the financial sector reforms was laid by recommendations of the Committee on Financial Systems 1991 (Narasimham Committee), which were implemented in parallel with the overall economic reforms of the 1990s.

The recommendations of the Narasimham Committee provided the blueprint for the first generation reform of the financial system (Jalan, 2000; Reddy, 1999), which consisted of: (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms⁹. These reforms had a significant impact on the banking sector (Sen and Vaidya, 1997).

By and large, financial sector reforms in India have proceeded in the following five directions (Klein and Palanivel, 2000):

The first important direction of reform has been the strengthening of market institutions and the granting of greater freedom to financial intermediaries. These reforms have been operationalised as a gradual liberalisation of interest rates, development of money and capital markets, and operational flexibility to banks in the management of their liabilities, subject to transparency and prudential norms.

⁹ In 1998, the Narashimham Committee II recommended amongst other matters a convergence of developing financing institutions with commercial banks or non-bank financial institutions and the adoption of the integrated system of regulation and supervision.

The second important element of reform concerns the 'safety' aspect of the financial system. Steps were taken to prescribe certain prudential standards for the financial system and to address certain structural weakness, which could minimise the occurrence of trouble in future. Measures such as income recognition norms, asset classification, meeting minimum capital adequacy standards through recapitalisation and devising a supervisory framework, can be considered to be moves in this direction.

The third important directional change has been the removal of operational constraints through lowering the share of pre-empted resources in the total resources of the banking system. This was achieved through gradual liberalisation of the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR).

The fourth directional change has been in the area of creating a more competitive environment with transparency in the financial sector through reform measures such as relaxation of entry and exit norms, reduction in public ownership in the banking industry and letting banks access capital market for meeting their fund requirement. It may also be noted that not only in the banking sector but also in the insurance sector there has been significant opening of private institutions.

The fifth and most important directional change has been the creation of a supervisory body, rigorous audit standards, improvements in technology and a stronger legal framework.

Thus, the first phase of financial sector reforms focused on improvements in prudential norms and standards, interest rate liberalisation, strengthening supervision, and increased competition in the banking sector.

A brief consideration now follows of two elements that occurred in the reform process to illustrate the nature of the process.

3.4.1 Deregulation of Interest Rate Controls

Deregulation of interest rates was the major component of financial reforms in India, introduced with the intention to promote financial savings and the growth of the organised financial system. Perhaps the single most important element of the financial sector reforms has been the deregulation of interest rates (Verma, 1998), in which respect, the following major attractive initiatives were implemented:

- Interest rates were freed on corporate bonds, most bank lending, and bank deposits above one year maturity.
- The introduction of auctions coupled with reduced pre-emption led to more market-determined interest rates for government securities.
- Administered interest rates are now confined mainly to short-term bank deposits, priority sector lending, and deposits of non-banking financial companies.

In 1994, the RBI abolished the minimum-lending rate for loans over Rs.0.2 million and gave banks greater freedom to determine the lending rate for different credit limits (Arun and Turner, 2002a). On the deposit side, since July 1996, the RBI has prescribed a maximum rate for deposits up to one year that gives freedom to

commercial banks to fix their own rates on domestic term deposits of over one year. In addition, the minimum period of maturity of term deposits has been reduced from 46 to 15 days during the reform period.

3.4.2 Prudential Regulation and Banking Supervision

From 1992–93, a set of prudential accounting norms such as income recognition, asset classification, provisioning for bad and doubtful debts and capital adequacy, has been implemented. These prudential norms have helped to promote the safety and soundness of the financial system and to impart greater transparency and accountability in operations. For instance, the banks are now required to make provisions on advances depending on the classification of assets into different groups such as standard asset, sub-standard asset, doubtful asset and loss asset. In order to provide a level playing field, these norms have been extended to major financial institutions and non-banking financial companies (Arun and Turner, 2002b).

The Board for Financial Supervision (BFS) was set up in 1994 to address issues related to on-site and off-site supervision of banks. Operational support to the BFS is provided by a Department of Supervision set up within the RBI. The BFS introduced the Off-site Monitoring and Surveillance System (OSMOS) with an objective of supervising the financial condition of banks in order to identify those that show financial deterioration, and thus being able to trigger a speedy on-site examination. The BFS has also introduced two models known as CAMELS (Capital Adequacy, Asset Quality, Management Earnings, Liquidity and Systems) and CACS (Capital Adequacy, Asset Quality, Compliance and Systems), for rating banks to help identify those which need special supervisory attention. The Narasimham Committee (1998)

recommended that punitive penalties should be imposed both for inaccurate reporting to the supervisor, or to the public.

Therefore, it is documented that India has made substantial progress towards improving the performance of the financial system and instituting a new regime with more autonomy, transparency and accountability. Compared to the experience of many other developing countries embarking on financial sector reform, India has treaded cautiously and in an orderly manner, which has helped in minimising the adjustment costs involved in the process. Indeed, the first phase of banking sector reforms initiated in pursuance of the recommendations of the Committee on Financial Sector Reforms, provided the necessary platform to the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. Keeping in view the major changes that took place in the macro- economic environment, and policy and institutional developments in the interim period, the GOI created the Committee on Banking Sector Reforms in 1997, under the Chairmanship of Mr. M. Narasimham, to review the record of implementation of financial system reforms recommended by the earlier Committee, and to look ahead and chart the reforms necessary in the future to make India's banking system stronger and better equipped to meet the global competition.

3.5 The Second Phase of Financial Sector Reforms

In 1998, the government appointed a second Committee on Banking Sector Reforms again under the chairmanship of M. Narasimham (Narasimham Committee II) to review what had been accomplished to date and to chart the agenda for a second

stage of banking sector reforms. The second Report of the Narasimham Committee II, which was submitted to the Government in 1998, made a number of recommendations covering institutional, supervisory, legislative and banking policy aspects. These recommendations related to capital adequacy, asset quality, non-performing assets, directed credit, prudential norms, disclosure requirements, systems and methods in banks' structural issues, rural and small industrial credit, regulation and supervision, the legal and legislative framework. Most of these recommendations were accepted and implemented by RBI (Press Information Bureau, Government of India, 2000). In detail, the major recommendations were:

1. Capital adequacy requirements should take into account market risks;
2. In the following three years, the entire portfolio of government securities should be marked to market;
3. The risk weight for a government guaranteed account must be 100% ;
4. The CAR to be raised to 10% from the then 8%; 9% by 2000 and 10% by 2002;
5. An asset should be classified as doubtful if it is in the sub-standard category for 18 months, instead of the present 24 months;
6. Banks should avoid "ever-greening" their advances;¹⁰
7. There should be no further re-capitalisation by the Government;
8. The NPA level should be brought down to 5% by 2000 and 3% by 2002;

¹⁰ "Evergreening refers to the practice of "managing" a bank's balance sheet by undertaking transactions which are designed to create cosmetic improvements. For example, a bank might extend funds to existing corporate borrowers to allow the latter to pay interest on outstanding loans thereby allowing their corporate clients to avoid default (and avoiding the need for the bank to declare loans to be non-performing). This latter method has been observed to be common in Japan see Watanabe, 2006). "Evergreening" is also known as "forebearance lending".

9. Banks having high levels of Non-Performing Loans Assets should transfer their doubtful and loss categories to ARCs, which would issue government bonds representing the realisable value of the assets;
10. There should be a move towards international practice of income recognition by introducing the 90-day norm instead of the present 180 days;
11. A provision of 1% on standard assets was required;
12. Government guaranteed accounts must also be categorised as Non-Performing Loans Assets under the usual norms;
13. Banks should update their operational manuals which should form the basic document of internal control systems;
14. There was identified to be a need to institute an independent loan review mechanism especially for large borrowing accounts, to identify potential Non-Performing Loans Assets;
15. Recruitment of skilled manpower directly from the market should be given urgent consideration;
16. To rationalise staff strengths, an appropriate VRS must be introduced;
17. A weak bank should be identified as one whose accumulated losses and net Non-Performing Loans Assets exceed its net worth, or one whose operating profits less its income on recap bonds, is negative for three consecutive years.

3.6 The Consequences of Reform

As a result of the reforms, the number of banks increased rapidly. In 1991, there were 27 public-sector banks and 26 domestic private banks with 60,000 branches, 24

foreign banks with 140 branches, and 20 foreign banks with a representative office.¹¹ Between January 1993 and March 1998, 24 new private banks (nine domestic and 15 foreign) entered the market; the total number of scheduled commercial banks, excluding specialised banks such as the Regional Rural Banks, rose from 75 in 1991-1992 to 199 in 1997/98. Entry deregulation was accompanied by progressive deregulation of interest rates on deposits and advances. From October 1994, interest rates were deregulated in a phased manner and by October 1997, banks were allowed to set interest rates on all term deposits of maturity of more than 30 days and on all advances exceeding Rs 200,000. While the CRR and SLR, interest rate policy, and prudential norms, have always been applied uniformly to all commercial banks, the Reserve Bank of India treated foreign banks differently with respect to the regulation (Shirai, 2002).

The noteworthy developments in the financial system over the period have been as follows (Bhide *et al.*, 2001):

- (a) Financial repression through statutory pre-emptions has been lowered. Illustratively, at end-March 2003, the CRR stood at 4.75% (legal minimum is 3%) and SLR at 25% (legal minimum). (See footnote 9 above for comparative data for earlier years).
- (b) The administered interest rate regime has been dismantled, allowing banks the freedom to choose their deposit and lending rates based on the prevailing market condition.

¹¹ Representative offices may not be allowed to hold deposits or extend credit. Their main business is to develop business contacts between local firms and their head offices, and collect local information for their head offices.

(c) Competition has been infused by allowing more liberal entry of foreign banks and permitting the operation of new private banks.

(d) A set of micro-prudential measures (capital adequacy requirements, income recognition, asset classification and provisioning norms for loans, exposure norms, accounting norms) has been stipulated.

Until 1991-92, all public sector banks were fully owned by the government. Since the onset of reforms, several relevant acts were amended to enable the state-owned banks to raise capital up to 49% from the public. By the end of March 2002, as many as 12 state-owned banks had accessed the capital market and raised around Rs.65 billion.

The major steps taken in the ten years 1992-2002 in the area of banking reform are listed in Appendix 2.

3.7 External Regulatory Influences on Indian banking

In the preceding sections I have considered domestic Indian regulatory structures and regulations relating to banking. At a number of points reference has been formally made or implications informally drawn to external regulatory influences which affect banking in India (e.g. International Accounting Standards and recommendations or other pronouncements of the Basle Committee on Banking Supervision). To complete our discussion of the regulatory setting for the research reported in this thesis I consider in this chapter relevant aspects of external regulatory influences which affect banking in India.

3.8 The Basel Committee on Banking Supervision

Disclosure in banking has been influenced by several initiatives and reports by international agencies. Some recent influential reports related to disclosure are from the Basel Committee on Banking Supervision. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the Central Bank governors of the group of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located. I shall now consider some of its recent work.

The statement of the Basel Committee on Banking Supervision (1998) entitled 'Enhancing Bank Transparency' which discussed the role of transparency and disclosure of information in effective market discipline and effective banking supervision and provided general guidance on regulatory frameworks for public disclosure and supervisory reporting and on core disclosures that should be provided to the public. The Basel Committee considered transparency to be a key element of an effectively supervised, safe and sound banking system. It recommended that banks, in regular financial reporting and other public disclosures, should provide timely information which facilitates market participants' assessment of banks. The report discussed the qualitative characteristics of information contributing to transparency, six broad categories for disclosure and a large number of recommendations regarding specific disclosures. The six broad categories of

information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency were identified as:

1. Financial performance;
2. Financial position (including capital, solvency and liquidity);
3. Risk management strategies and practices;
4. Risk exposures (including credit risk, market risk, liquidity risk, and operation, legal and other risks);
5. Accounting policies; and
6. Basic business management and corporate governance information.

In a revised version of another report first issued in 1998, *Sound Practices for Loan Accounting and Disclosure* (1999) twenty-six principles for improved accounting and disclosure practices are presented, of which thirteen are recommendations for disclosures relating to credit risk in lending. The recommendations in this *Loan Accounting* report on disclosure were subsumed into a more comprehensive set of guidelines for credit-risk disclosures included in the Basel Committee's July 1999 report *Best Practices for Credit Risk Disclosure*. This report presents twenty-four specific guidelines for disclosure in five broad areas: accounting practices, credit risk management, credit exposure, credit quality, and earnings. The guidelines applied to credit risk related to lending as well as to other activities, such as trading, investing in securities, asset management, and management of liquidity and funding.

The Committee issued a consultative paper entitled 'A New Capital Adequacy Framework: Pillar 3 Market Discipline' which discussed the importance of reliable and timely information and the provision of information on capital adequacy. The

paper provided detailed guidance on what disclosures should be made in order to advance the role of market discipline in promoting bank capital adequacy. The Committee recommended six disclosure guidelines in the areas of the structure of capital, risk exposures and capital adequacy that bring market discipline in promoting bank capital adequacy. Their recommendations were as follows:

- 1) A bank should disclose the amounts of its components and structure of capital based on the definitions contained within the Basel Capital Accord.
- 2) A bank should disclose information on its accounting policies for the valuation of assets and liabilities, provisioning and income recognition.
- 3) A bank should disclose qualitative and quantitative information about its risk exposures including its strategies for managing risk;
- 4) A bank should disclose its capital ratio and other relevant information on its capital adequacy on a consolidated basis and should also disclose measures of risk exposures;
- 5) A bank should provide an analysis of factors impacting on its capital adequacy position and this would include:
 - a) changes in capital structure and the impact on key ratios and overall capital position;
 - b) its contingency planning, should it need to access the capital markets in times of stress;
 - c) its capital management strategy and consideration of future capital plan;
 - d) the impact of any non-deduction of participations in banks and other financial institutions.

- 6) A bank is encouraged to discuss its structure and process of allocating economic capital to its business activities.

In a paper 'Best Practices for Credit Risk Disclosure' (2004) issued by the Committee guidance was presented on best practices for public disclosure of credit risk in banking institutions and discussed related supervisory information needs. The Committee identified the following five broad areas in which banks should provide more detailed disclosures:

1. Accounting policies and practices: bank should disclose information about the accounting policies, practices and methods it uses to account for its credit risk exposures and also it should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.
2. Credit risk management: A bank should disclose qualitative information about the nature of credit risk in its activities and describe how credit risk arises in those activities.
 - a. A bank should disclose information on the management, structure and organisation of its credit risk management function.
 - b. A bank should disclose qualitative information on its credit risk management and control policies and practices.

- c. A bank should disclose information on its techniques and methods for managing past due and impaired assets.
- d. A bank should provide information on its use of credit scoring and portfolio credit risk measurement models.
- e. Credit exposures: A bank should disclose balances of credit exposures, including current exposure and, where applicable, future potential exposure, by major categories.

3. Credit quality:

- a. A bank should provide summary information about its internal rating process and the internal credit ratings of its credit exposures.
- b. A bank should disclose total credit exposures by major assets category showing impaired and past due amounts relating to each category.
- c. A bank should disclose the amounts of specific, general and other allowances established against each major asset category.
- d. A bank should disclose a reconciliation of changes in the allowances for credit impairment.

- e. A bank should disclose credit exposures on which the accrual of interest or other contractual cash flows - in accordance with the terms of the original agreement - has ceased because of deterioration in credit quality.
 - f. A bank should disclose summary information about credit exposures that have been restructured during the year.
4. Earnings: A bank should provide information on revenues, net earnings and return on assets.

All of the disclosure best practices were to be applied in line with the materiality principle. However, institutions were encouraged to provide as much of the information listed as possible in their audited financial statements, i.e. primary financial statements and supporting notes. In particular, disclosures of accounting policies were to be in the audited part of the financial report. Information on risk management and control policies may be disclosed in the unaudited part of the financial report, e.g., in management's discussion and analysis. The report also mentioned that experience from around the world indicated that poor credit quality, coupled with weak credit risk management practices, continued to be a dominant factor in bank failures and banking crises. Therefore, the Committee recommends that banks should increase their level of disclosure to comply with this guidance in line with the nature, size and complexity of their activities.

3.9 The US Financial Accounting Standards Board

As the professional accountancy body responsible for the setting of accounting standards for the US the Financial Accounting Standards Board (FASB) is an important influence on bank accounting regulation and practice in its own jurisdiction and beyond the US. In 2001 the FASB issued a discussion paper entitled *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures* which was one of three sections of a broader study - the Business Reporting Research Project - to determine, in selected industries including banking, the kind of business information that corporations are reporting outside of financial statements (see www.fasb.org). The objective of this report is to help companies (the preparer community) improve their business reporting by providing evidence that many leading companies are making extensive voluntary disclosures and by listing examples of those disclosures. The examples serve to provide companies with helpful ideas of how to describe and explain their investment potential to investors. The basic premise underlying this Business Reporting Research Project is that improving disclosures makes the capital allocation process more efficient and reduces the average cost of capital. The examples are not a list of recommended disclosures. They do illustrate, however, show companies are communicating with investors. The term *voluntary disclosure*, as used in the report, describes disclosures, primarily outside the financial statements that are not explicitly required by GAAP or an SEC rules.

Voluntary disclosures of business information are classified for each industry within six categories. The first five categories are those included in the American Institute of Certified Public Accountants (AICPA) *Special Committee on Financial*

Reporting's comprehensive business reporting model. The sixth category pertaining to intangible assets was added because intangible assets are considered to be of increasing importance to companies and investors today. The six categories are as follows:

1. *Business data* (for example, high-level operating data and performance measurements that management uses to manage the business).
2. *Management's analysis of business data* (for example, reasons for changes in the operating and performance-related data, and the identity and past effect of key trends)
3. *Forward-looking information* (for example, opportunities and risks including those resulting from key trends; management's plans, including critical success factors; and comparison of actual business performance to previously disclosed opportunities, risks, and management's plans)
4. *Information about management and shareholders* (for example, directors, management, compensation, major shareholders, and transactions and relationships among related parties)
5. *Background about the company* (for example, broad objectives and strategies, scope and description of business and properties, and impact of industry structure on the company)
6. *Information about intangible assets* that have not been recognised in the financial statements.

3.10 International Accounting Standards Committee/International Accounting Standards Board

From 1973 until it was renamed and reorganised in 2000, the structure for setting International Accounting Standards was known as the International Accounting

Standards Committee, a body based in London and comprising the professional accountancy bodies of a wide range of countries. On 1st April 2001, the International Accounting Standards Board (IASB) assumed accounting standard-setting responsibilities from International Accounting Standards Committee. The objectives of the IASB are:

(a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

(b) to promote the use and rigorous application of those standards; and

(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

(d) to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions. (IASB, 2001)

Given these objectives, IASC/IASB standards and other pronouncements are potentially strong influences on company financial reporting in general worldwide and on banking companies also.

The IASC issued an accounting standard IAS 30, *Disclosures in Financial Statements of Banks and Similar Financial Institutions* in 1990 following the 1987 issued Exposure Draft E29 *Disclosures in Financial Statements of Banks* and modifications and re-exposures (as E34 *Disclosures in Financial Statements of Banks and Similar Financial Institutions*). IAS30 was reformatted in 1994 and was amended by IAS 39 *Financial Instruments: Recognition and Measurement*, effective from 1st January 2001. On 18th August 2005 IAS 30 was superseded by IFRS 7 *Financial Instruments: Disclosures* (effective 1 January 2007).¹²

The objective of IAS 30 was to prescribe appropriate presentation and disclosure standards for banks and similar financial institutions which supplement the requirements of other accounting standards. The intention was to provide users with appropriate information to assist them in evaluating the financial position and performance of banks, and to enable them to obtain a better understanding of the special characteristics of the operations of banks.

The standard prescribed presentation and disclosure requirements required that a bank's income statement should group income and expenses by nature. Further, a bank's income statement or notes should report the following specific amounts: interest income, interest expense, dividend income, fee and commission income, fee and commission expense, net gains or losses from securities dealing, net gains or losses from investment securities, net gains or losses from foreign currency dealing, other operating income, loan losses, general administrative expenses, and other operating expenses. A bank's balance sheet should group assets and liabilities by

¹² IFRS 7 will not be discussed here.

nature and list them in liquidity sequence which specific requirements for line items requiring disclosure. The standard included guidelines for the limited circumstances in which income and expense items or asset and liability items are offset. The standard required that banks must disclose the fair values of each class of its financial assets and financial liabilities as required by IAS 32 and IAS 39. Disclosures were also required for specific contingencies and commitments (including off-balance sheet items) requiring disclosure; specified disclosures for the maturity of assets and liabilities; concentrations of assets, liabilities and off-balance sheet items; losses on loans and advances; general banking risks; and assets pledged as security.

3.11 Conclusion

The previous chapter analysed the development of banking and related financial markets in Indian and have considered corporate financial disclosure regulations, including those especially established for banks. This chapter has considered external regulatory influences which are likely to have had an influence on Indian banking. In addition certain of these bodies and their recommendations or rules are used in the determination of the items to be analysed as part of voluntary disclosures in the empirical sections of this thesis. As such this discussion provides a back-drop against which the disclosure behaviour of banks may be analysed. Since the financial reforms which commenced in 1991, there have been significant favourable changes in India's highly regulated banking sector. This chapter and the previous one have documented the reform process and its consequences. A hallmark of the reform process in India has been its 'gradualism', which was the outcome of India's democratic and highly pluralistic political environment in which reforms could be

implemented only if based on a popular consensus (Ahluwalia, 2002). Indeed, there have been considerable steps taken in the banking sector in India since 1969 with all the evidence demonstrating that India has reformed its practices in almost every aspect, including disclosure and transparency and corporate governance, which have been treated with great priority by the policy-makers. Moreover, Muniappan (2002) made it clear that the transparency and disclosure standards recommended in International Accounting Standards have been implemented in a phased manner. Disclosure requirements have been broad-based and with effect from 31 March 2000, banks have been advised to disclose their maturity pattern of deposits, borrowings, investments and advances and foreign currency assets and liabilities, movements in Non-Performing Loans Assets and lending to sensitive sectors. From the year ended 31 March 2001, banks were advised to disclose total advances against shares and total investments made in equity shares, convertible debentures and equity-oriented mutual funds. Further, from the year ended 31 March 2002, the banks have been required to disclose movement of provisions held towards NPAs and movement of provisions held towards depreciation of investments, the total amount of standard/sub-standard assets subjected to CDR as well as in other areas. I now turn to an examination of the research literature on disclosure, in particular those studies utilizing the disclosure index methodology.

CHAPTER FOUR

DISCLOSURE INDEX STUDIES: REVIEW OF THE ACADEMIC AND PRACTITIONER LITERATURE

4.1 Introduction

This chapter provides a review of literature on disclosure studies, focusing on those studies which use disclosure index approaches. In general, the disclosure literature has developed along a systematic path. Studies can be classified into three main phases. Firstly, and beginning in the 1960s researchers sought to establish methodologies to quantify items disclosed in corporate financial reports, especially in annual financial statements. This approach is still commonly pursued by researchers. In the second phase, researchers have attempted to construct stronger theoretical underpinnings to develop methodologies and to explain empirical findings on disclosure behaviour. In the third phase, researchers have directed their attention towards combining theory and practice, with a view to determining the optimal firm-to-outsider communication relationships that should exist

In this chapter the literature review has been organised along the following four broad themes: firstly, I review studies of disclosure which are directed to non-banking companies (and thus refers to companies in various economic sectors) and this theme also combines research covering both developed and developing country contexts; secondly, I review disclosure studies related specifically to banking companies; thirdly I review research studies related specifically to Indian banking companies; and finally the chapter considers studies relevant to banks but conducted by international agencies and related bodies rather than individual academic

researchers. The chapter is organised in the following way: Section 4.2 reviews literature in the context of general disclosure, that is relating neither to India nor to banking; Section 4.3 describes only general disclosure of Indian non financial companies; Section 4.4 contains the discussion of studies specifically on banking disclosure; Section 4.5 discusses the only available academic study of Indian banking disclosures; Section 4.6 analyses literature in the context of international organisations, agencies, and others and Section 4.7 draws conclusions and links the discussion to chapter five which discusses methodology for the research reported in the thesis.

4.2 Literature Review of General Disclosure Studies

Cerf (1961) undertook what was a pioneer study that used a disclosure index methodology to measure the extent of corporate financial reporting of a sample of US companies. Cerf surveyed 527 companies' annual reports listed on the New York Stock Exchange (NYSE) and other US exchanges. In total, 31 items of information were included in the disclosure index, the items being based on a study of the investment decision process, a review of relevant literature, interviews with security analysts, and an examination of analysts' reports. In preparing the disclosure index, the focus was on the needs of professional financial analysts. This study was an early example of a weighted index approach (with weights ranged from one to four) and the disclosure index was given a maximum score of 68. The final index for each company was a percentage and was calculated by dividing the actual scores attained by their maximum possible scores. Four key attributes were identified as potential explanations of variations in disclosure. These were company size (measured by total asset value), ownership (measured by number of shareholders), method of trading

shares (i.e. listing status), and profitability (measured by the rate of return), and they were tested in relation to the disclosure index using ordinary least squares regression. The results indicated that there was a positive association between disclosure scores and three independent variables (namely company size, number of shareholders, and the rate of return). The study also revealed that the companies that were listed on the NYSE, disclosed more information than those listed on regional stock exchanges. However, the researcher found no relationship between the extent of disclosure and listing status.

Choi's (1973) study investigated the annual reports of 72 firms that were Eurobond participants prior to 1971. He used a matched pair approach to examine 36 unweighted and weighted items disclosed in annual accountants, finding that entry to the European capital market was related to improvements in disclosure.

Buzby (1974) undertook a study with the objectives of (i) measuring the extent of disclosure of each of a range of specified items, (ii) measuring the relative relationship between the importance of an item and its extent of disclosure, and (iii) measuring the average extent of disclosure of the items taken as a whole. Buzby used a disclosure index containing 39 items of financial and non-financial information based on previous studies. In order to measure the relative importance of each of the items of disclosure, he surveyed a sample of 500 financial analysts selected from the US 'The Financial Analysts Federation' (using the national membership directory of US financial analysts). The respondents were asked to rate specified items of information on a 0 to 4 scale with a '0' being assigned if the item was not considered necessary to appear in an annual report, and a '4' if it was considered essential to

appear in an annual report. He constructed a weighted disclosure index for each of the items and applied this to a sample of annual reports for 88 small and medium-sized US companies for the year 1970-1971. Two samples were used in the study, the first being drawn from 200 companies listed in *Moody's OTC Industrial Manual* and every fourth company listed in the OTC (i.e. Over-the-Counter) quotation section of *The Wall Street Journal*, and the second being drawn from companies listed on the NYSE or American Stock Exchange (AMEX). The samples were matched on the basis of assets size, three-digit enterprise standard industrial classification codes, and annual report dates. Every annual report was scored against the disclosure index. The results of Buzby's research indicated that many of the items in his disclosure index were inadequately disclosed in the sample companies' annual reports and the correlation between the relative importance of the items and the extent of their disclosure was small. He found a positive association between the extent of disclosure and asset size, but found no significant association between listing status and the extent of disclosure.

Barrett (1975) studied the annual reports of 103 firms in an early cross-country study using a sample of companies located in France (15), Germany (15), Japan (15), Sweden (15), the Netherlands (13), the UK (15), and the US (15), over the period 1963-72. His research involved a comparison of disclosure indices and sub-indices. Seventeen unweighted and weighted items were examined. He found that the overall extent and quality of US annual report disclosure was not better than that of UK firms and that in specific disclosure areas there were differences among countries.

Stanga (1976) selected a sample of 80 US companies and evaluated their corporate annual reporting using a disclosure scoring sheet of 79 items of information which were weighted according to replies received from a questionnaire sent to financial analysts. In contrast to other studies using explanatory variable for disclose the size variable selected for study was sales rather than assets. Stanga also investigated industry type, a variable not previously selected by researchers, and found that corporate size was not a significant explanatory variable, but that industry type was.

Belkaoui and Kahl (1978) conducted a survey of 200 Canadian companies, using a total of 30 items of accounting which the researchers judged to be relevant to Canadian context. In order to calculate the mean weight of each item, they prepared and distributed a questionnaire to 400 financial professional (i.e. 200 chartered accountants and 200 financial analysts), then calculated mean weights on the basis of the responses. The researchers also sought to establish the relationship between the extent of disclosure and certain variables such as size, profitability, liquidity, capitalisation and industry variation. The findings of the study indicated that size and liquidity were positively associated with the level of disclosure but the other two explanatory variables were insignificant.

Firth's (1979) research aimed to examine whether the level of disclosure in corporate annual reports was associated with the size of the company, listing status, and auditors. He constructed a disclosure index containing 48 items and sent a questionnaire to 120 financial analysts working for stockbrokers and investment institutions, with a request to weight the items in terms of importance using a five-point scale (the same scale used in his earlier work, Firth 1978). The rate of response was 38.3%. The mean weights were applied to the annual reports for 1976 of three

samples of UK companies. These samples consisted of 40 companies with no stock exchange listing, 40 stock exchange listed companies who were paired with the unlisted companies on the basis of size and industry, and 100 stock exchange listed companies (these being every 10th company appearing in *The Times 1000* Largest companies). The study revealed that both size and the stock market listing variables were related to disclosure, but the auditor factor had no significant, and concluded that companies with stock market listings released significantly more information than companies that were unlisted. .

Chow and Wong-Boren (1987) studied the extent of voluntary financial disclosure practices of 52 Mexican corporations for the year 1982. Three firm characteristics, firm size, financial leverage, and proportion of assets in place, were taken to explain the extent of disclosure. A total of 89 items of information was included in the disclosure index. A questionnaire survey was conducted and using a seven-point scale (the end-points were: (1) 'Of no importance at all', and (7) 'Of utmost importance'), the researchers asked for judgements on the importance of the 89 items considered significant from the viewpoint of 106 loan officers of 16 Mexican Banks. They used two disclosure scores for their sample companies, a weighted score and an unweighted score. They ran multiple regression analysis to explain cross-sectional variations using as explanatory variables firm size (measured by market value of equity plus the book value of debt), financial leverage (measured by the book value of debt divided by size), and proportion of assets in place (computed by dividing the book value of fixed assets, net of depreciation, by total assets). The result showed that only asset size had a statistically significant coefficient but the two other variables (financial leverage and assets in place) did not show any significance to the

extent of voluntary disclosure. The study revealed that the extent of voluntary disclosure increased with firm size.

Wallace (1988a) considered the extent of financial disclosure by profit-seeking publicly-quoted companies in Nigeria, and compared the level of actual disclosure with accounting and financial disclosure requirements. He also pooled the views of various users of corporate annual reports in the country. A survey of 47 companies out of a population of 87 companies was made between 1982 and 1986 on the basis of availability of corporate annual reports, access to other documents and permission to interview the head of accounts of companies. The researcher developed an index of disclosure consisting of 185 items (both mandatory items, numbering 120, and voluntary items, numbering 65), based on previous research studies, disclosure required by law, accounting standards recommended by the IASC or the Nigerian Accounting Standards Board (NASB), and the rules of the Nigerian Stock Exchange (NSE). The 185 items of information related to seven parts of the corporate annual reports of sample companies, i.e. balance sheet, income statement, other financial statements, statistical data, valuation methods, social data, and historical data. Wallace surveyed a total of 470 respondents including accountants (148), financial analysts (58), civil servants (49), professionals (45), managers (82), and investors (88). The respondents were asked to rate disclosure items according to their perceived importance on a five-point scale. Two types of disclosure indexes were constructed, weighted and unweighted. In order to identify which user group was better served, six weighted indexes were also constructed on the basis of the perceived importance of items of each user group.

The study showed that there was a high level of disclosure of balance sheet and historical survey and valuation methods. In contrast, there was an apparent weakness in respect of disclosures relating to projections, statistical data, social reporting, and income statement items. As to the mean score of the perceptions of the six user groups regarding the importance of various sections of annual reports, Wallace found the highest score in the balance sheet sections, followed by income statement, which was remarkably consistent with the study of *Chang et al (1983)*. It was found that Nigerian reporting practice demonstrates poor compliance with disclosure requirements, and that the level of disclosure of information was relatively low compared to the needs of users.

Cooke's (1991) study sought to investigate the impact of certain firm-specific characteristics on voluntary disclosure in Japanese corporate annual reports for the year 1988. It assessed voluntary disclosure on the basis of sample companies' Commercial Code accounts, and Securities and Exchange Law. The study sampled 42 Japanese corporations which were categorised into three groups, firstly the unlisted groups, secondly the Tokyo Stock Exchange (TSE) group, and thirdly a 'multiple' group (i.e. listed on the TSE plus at least one overseas listing). The relative level of disclosure was measured by an index calculated as the ratio of actual disclosure scores awarded to a company to the scores which that corporation might be expected to disclose. Actual scores were calculated from 106 items of information that were not required to be disclosed by Japanese law. In order to test whether the extent of voluntary disclosure was determined by size, quotation status, and industry type, the researcher used a linear regression model. Due to the problem of multicollinearity (associated with size variables), he used three regression models in a step-wise procedure. Listing status was found to be a significant explanatory variable

in all three models. The study also showed that size was the single most important independent variable that helped to explain variations in voluntary disclosure in Japanese corporate annual reports.

In a subsequent study, Cooke (1992) provided a further contribution using Japanese financial reporting data, specifically reporting on the impact of size, stock market listing, and industry type of disclosure, both voluntary and mandatory. Cooke examined the extent of financial disclosure in Japanese corporate annual reports and also assessed whether a number of independent variables (namely size, stock market listing, and industry type) affected levels of disclosure. The study covered 35 Japanese corporations on the basis of random sampling. By considering the interests of a wide range of users, a total of 165 items of information were included in the disclosure index. The approach to the scoring of items was dichotomous, an item scoring one if disclosed, and zero otherwise. A linear regression model was used to examine the relationship between independent variables (namely size, stock market listing, and industry type) and dependent variable (disclosure scores). It was found that multiple listed corporations disclosed more information than corporations listed only on the T SE. Size was also found to be an important influence in the level of disclosure. It also appeared that Japanese manufacturing corporations disclosed significantly more information than other types of corporations.

In a third related study, Cooke (1993), again basing his work on Japanese company data, examined differences in the extent of disclosure by companies that were classified by quotation status and the analysis was extended to both the Commercial Code (CC) and the Securities and Exchange Law (SEL) accounts. Cooke measured aggregate disclosure which included both mandatory and voluntary disclosure

information i.e. financial and non-financial information, audited and unaudited financial statements, management's analysis of operations and other supplementary information in corporate annual reports. A total of 195 (voluntary, 137 and mandatory 58) disclosure items was selected, and an unweighted disclosure model was used. The study covered the annual reports of 48 companies consisting of 13 unlisted and 35 listed companies (including multiple companies of 10), for the year 1988. Four hypotheses were tested and the results indicated that no differences were found between domestically-listed companies and unlisted companies in disclosing information, and the level of disclosure between domestically-listed and multiple companies. Additionally, the results showed that there was no association between the extent of disclosure and the quotation status of companies.

Abayo et al (1993) examined the reporting practices of Tanzanian companies. It initially covered a potential sample of 248 companies which was drawn by a simple random process from the Tanzanian Registrar of Companies' Register and the Standing Committee on Para-statal Organisations directory. However, following further evaluation the final sample was reduced to 51 companies by being constructed on four criteria for inclusion.¹³ A disclosure index of 88 items was constructed, and designed to capture a range of material items required by either accounting standards or statute. A second disclosure index of voluntary items was also developed, consisting of 44 items. Using regression analysis the researchers found weak relationships between the level of mandatory and voluntary information disclosures and the type of audit opinion issued to sample companies and the

¹³ The four criteria were as follows: i. if annual reports are available; ii. if companies are profit seeking; iii. if they fall under the NBAA (National Board of Accountants and Auditors); and iv. if they fell into four industrial groups - distribution, chemical, textiles, and metal goods

timeliness of their financial reports. However, it was also found that a positive association existed between the extent of voluntary disclosure and compliance with mandatory standards, and between the type of audit opinion the timeliness of the corporate annual reports.

Ahmed and Nicholls (1994) empirically assessed the extent of statutory information disclosure in the corporate annual reports of 63 listed non-financial companies in Bangladesh during the 1987-88 fiscal period. The researchers also investigated whether a significant relationship existed between mandatory disclosure and five selected company attributes. The company attributes identified for use in the analysis were size, total debt, a dummy for whether the company was a subsidiary of multinational parent, qualifications of the company's principal accounting officer, and size of the company's audit firm. An unweighted disclosure index (with the standard dichotomous approach) was adopted to determine the disclosure level of corporate annual reports, and the compliance level was assessed against the combined statutory requirements of the Bangladesh Companies Act 1913 (actually for India as a united country) and the Securities and Exchange Rules 1987. Their findings showed that the degree of compliance with mandated disclosure requirements was low amongst Bangladesh companies with none of the sample companies complying fully with statutory requirements by disclosing all mandatory information. Multiple regression techniques were used to test the relationship between degree of disclosure compliance and independent variables (and it was found that subsidiaries of multinational companies, and companies whose accounts were audited by large audit firms were associated with disclosure. However, their

study also showed that the qualification of the principal accounting officer was not statistically significantly associated with disclosure compliance.

Wallace *et al* (1994) examined the “comprehensiveness” as they termed it of the financial disclosure in the annual reports and accounts of 50 non-financial Spanish firms (30 firms were listed on both the Madrid and Valencia stock markets and the remaining 20 firms were unlisted). “Comprehensiveness” was measured by a disclosure index representing the extent of details given on 16 items of mandated information in a firm’s annual report and accounts, relative to the total possible details that each firm was expected to give. The independent variables used to test variations in comprehensiveness of disclosure were classified into three non-mutually exclusive categories: structure-related (size measured by total assets and total sales and gearing ratio measured by debt/equity ratio), performance-related (liquidity ratio, earnings return and profit margin), and market-related variables (industry type, listing status and auditor type), a classification which was consistent with the study of Hossain *et al.* 1994 (see p. 341). Because of the potential for collinearity, the researchers estimated the coefficients of the explanatory variables using two models. The first was a ‘reduced regression model’ that included one structure-related variable (assets), one performance-related variable (liquidity ratio), and the three market-related variables. The second model was a regression model that dropped one of the two highly correlated corporate size variables (sales and total assets). Their reduced regression model found that the coefficient of the variable ‘log of assets’ was significantly positive at the 5% level ($p < 0.003$), suggesting that the index of comprehensiveness of disclosure of mandatory items was increasing with firm size, a finding similar to the results of previous studies (as noted on p. 49). However, the coefficient of liquidity was significantly negative suggesting that the

sample Spanish firms with higher liquidity ratios tended to provide less detailed information in their corporate annual reports and accounts. The findings of the ranked OLS regression model indicated that the relationship between asset size and index of comprehensiveness of disclosure was significantly positive. The sales variable was excluded since the R^2 suggested that the results of the regression that included the size variable on sales (but not assets) had less explanatory power than the results which included assets (but not sales). The results also indicated a variation between the level of comprehensive disclosure and the listing status variable.

The study by Hossain *et al* (1994) empirically examined the influence of six firm-specific characteristics, namely: firm size, ownership structure, leverage, assets-in-place, size of the audit firm, and the foreign listing status, on the general level of voluntary disclosure in the annual reports of Malaysian companies listed on the Kuala Lumpur Stock Exchange (KLSE). In total, 67 publicly-traded companies were randomly selected from the 279 non-financial companies listed on the KLSE in the year of 1991. Having considered a large number of prior studies, the researcher constructed a disclosure index of 78 discretionary disclosure items. Six hypotheses were tested using both univariate and multivariate statistical techniques and the results indicated that firm size, ownership structure and foreign listing status were statistically significantly related to voluntary disclosure levels. In addition, firm size was the most strongly significant variable associated with the extent of voluntary disclosure (at $p < 0.05$). In contrast, leverage, asset-in-place, and size of audit firm did not appear to be important factors/in explaining voluntary disclosure by the sampled firms.

In a separate study with different co-authors Hossain *et al* (1995) examined empirically the relationship between five firm-specific characteristics and the general level of accounting information voluntarily disclosed by companies listed on the New Zealand Stock Exchange. Five firm-specific characteristics were examined, i.e. firm size, leverage, assets-in-place, type of auditor, and foreign listing status. In total, 55 companies were covered by the study and were selected by using a stratified random sample from the *Share Market Review* (1991), published by the New Zealand Stock Exchange. A disclosure index of 95 discretionary items was constructed by considering previous studies on disclosure indices, and after an examination of New Zealand Accounting Standards, as well as following discussions with three practising accountants. The researchers used an Ordinary Least Square model as a multivariate test to assess the effect of each individual variable on disclosure. The empirical evidence suggested that firm size, leverage, and foreign listing, were statistically related to the level of information voluntarily disclosed by New Zealand companies in their published annual reports. However, no significant association between type of auditor and the extent of voluntary disclosure was found.

Wallace and Naser (1995) studied the comprehensiveness of mandatory disclosure in the corporate annual reports of firms listed on the Stock Exchange of Hong Kong (SEHK) with three basic objectives. The first objective was to understand accounting and corporate reporting in Hong Kong, the second was to analyse the disclosure characteristics of SEHK-listed firms, and the third was to compare and contrast the environment of financial reporting in Hong Kong. In doing this, the researchers

applied multivariate analysis to selected independent variables.¹⁴ A total of 80 firms from the 417 firms listed on the SEHK were selected. The scoring scheme information included in the disclosure index represented the total details given by a firm on 30 disclosure items as a percentage of the total details (142) which each firm could disclose. The researchers used both an ordinary least squares regression model and a rank OLS regression model to examine the incremental explanatory power of the independent variables. In all comparative estimations the equations using ranked variables had more explanatory power than alternative models. However, the results of the ranked OLS regression were not dissimilar from those of the unranked OLS regression results. The results indicated that profit margin (*p value* = 0.016), asset (*p value* = 0.000), scope (*p value* = 0.033), and audit firm (*p value* = 0.047) were significant predictors of the unranked disclosure index. Profit margin (*p value* = 0.021), asset (*p value* = 0.013), and auditor (*p value* = 0.030) were also significant predictors of the ranked disclosure index. The results also suggested in a tentative manner that SEHK-listed firms with registered offices in a foreign country did not possess comparative advantages in the provision of comprehensive disclosure in corporate annual reports over SEHK-listed firms with HK-registered offices. Another important finding of the study suggested that Hong Kong firms with low profit margins tended to score highly on the comprehensiveness of their corporate annual reports.

¹⁴ As with Wallace *et al* 1994 (see p. 44 in particular) the researchers selected variables on the basis of three non-mutually exclusive categories: structure-related, performance-related and market-related (see also Land and Lundholm 1993, p. 248). They considered debt-equity ratios, firm size and proportion of shares held by outsiders as structure-related variables, profit margin, earnings return and liquidity ratio as performance-related variables, and market capitalisation, scope of business operations, and auditor size influence as market-related variables.

Raffournier (1995) sought to relate the extent of disclosure in the annual reports of a sample of Swiss listed companies to possible determinants representing agency and political costs. Raffournier chose Switzerland based on the fact that, prior to the implementation of the new Swiss company law on 1 July 1992, Swiss disclosure requirements were, relative to requirements in other developed industrial countries, very low so that the major part of the content of the annual report could be considered as voluntarily disclosed. A sample of 161 industrial and commercial firms (thus excluding financial and insurance firms) for the year 1991 was chosen for the study. To reduce the subjective element, Raffournier used a list of items derived from the Fourth and Seventh EU Directives on Company Law consisting of 29 items of voluntary information. He used an unweighted disclosure index as the dependent variable and chose five independent variables which were size (measured in four ways, namely total assets, the logarithm of total assets, sales, and the logarithm of sales), leverage (measured by the debt-on-total-assets ratio), and fixed assets intensity (measured by the percentage of fixed assets in total assets), an ownership variable (defined as the percentage of shares not held by known shareholders), a variable capturing the level internationality (measured by the exports-on-sales ratio), and profitability (measured by net income as a percentage of net worth). He also included an auditor's size variable set as a dummy variable taking the value one if the audit firm was a (as then) Big Six firm and zero otherwise. He conducted both univariate and multivariate analyses to analyse determinants of the extent of disclosure of sample companies. The results indicated that size and internationality seemed to play a significant role in the disclosure policy of sample firms, thus, large and internationally-diversified companies tended to disclose more information than smaller sample companies which were largely domestic enterprises. Company size,

internationality, assets-in-place of fixed assets and auditor's size variables were significant at the 5% level in univariate analyses. Under multivariate analysis, weaker results were found for internationality, profitability and auditing firm variables, all having significant influence at the 10% level.

Schadewitz and Blevins (1997) reviewed 573 interim reports submitted to the Helsinki Stock Exchange over the period 1985-93. Indices for voluntary disclosures were developed and tested via regression analysis. Statistically significant relationships were identified between the degree of voluntary disclosures in interim statement and explanatory variables related to corporate governance, business risk, growth, growth potential, size, and degree of regulation. No statistically significant relationships were found for other variables for financial risk, capital structure, and stock valuation methods.

Inchausti's (1997) study was directed to the determination of the factors that explained the level of information disclosure by Spanish companies. It also focused on broad notions of positive accounting theory, drawing on agency theory, political process theory, and signalling theory. A total of 49 companies (excluding financial institutions, insurance companies and investment funds) were selected for analysis for the three financial years 1989 to 1991. The information disclosed by the sample companies was measured through an disclosure (termed "information") index, based on a list of 50 items of information (both voluntary and compulsory), grouped into four categories¹⁵ according to the sources of regulation in force in Spain over the

¹⁵ These categories were grouped as stock exchange related: 14 items of compulsory information that were based on stock exchange legislation, law: 12 items of information that were based on the Spanish Law 19/1989, Plan: four items of information that were based on the Spanish General Accounting Plan

period of the study together with pre-existing literature. The researcher used a weighted disclosure index on the grounds that it allowed distinctions to be made for the relative importance of items of information to the users of accounts. Seven hypotheses were tested by regression models. The independent variables included in the analysis were firm size, stock exchange listing, profitability (measured as rate of return on total assets, and return on equity), leverage, audit firm size, industry, and dividend pay-out ratio. The results indicated that size, auditing firm size, and stock exchange listing status, provides a statistically satisfactory basis for explaining the attitude of firms regarding the provision of financial information. Other variables such as profitability, leverage, dividends, and industry, were rejected as statistically insignificant explanations by the analysis.

Cooke (1998) represents a significant theoretical study of under-lying measurement issues in disclosure index research studies. In this paper he addressed the problem of empirically estimating the relation between accounting variables, and examined the application of rank and normal scores regression in accounting disclosure studies. Cooke also discussed a number of transformations including rank regression, and sought to extend the latter by mapping observations on to the normal distribution rather than on to positive integers. Additionally, the study described in detail data examination and transformation procedures, the advantages and disadvantages of rank regression in accounting research, and the development of the normal scores approach. Finally, he examined the application of regression based on untransformed data on the log odds ratio of the dependent variable, and on ranks and regression using normal scores, to data on disclosure of information in the annual reports of

(1990), and voluntary items: 20 items of information that were voluntary and were based on a review of previous studies.

companies in Japan and Saudi Arabia. He found that regression using normal scores has some advantages over ranks that in part depend on the structure of the data. However, he concluded that case studies demonstrated that no one procedure is best, but rather that multiple approaches are helpful to ensure results are robust across methods.

Craig and Diga (1998) analysed corporate annual report disclosure practices in five ASEAN countries, namely Singapore, Malaysia, Indonesia, the Philippines and Thailand. The purpose of this research was twofold: firstly, to ascertain the extent, pattern and nature of corporate disclosure in these countries, and secondly, to reveal whether existing disclosure requirements would be conducive to accounting harmonisation in the ASEAN region. They surveyed 145 public companies listed on ASEAN stock exchanges which were selected randomly from companies listed on principal national stock exchanges as at 31 December 1993. They chose 30 companies each from Singapore, Malaysia, Philippines, and Indonesia, and 25 companies from Thailand. The companies sampled were from seven industry groups.¹⁶ In total, 530 items of information were included in the disclosure index adopted after considering the company legislation and stock market regulations in the various countries. The researchers determined what they considered to be 'substantially common' items comprised 270 specific disclosure requirements which were common to at least four of the five ASEAN countries. Parametric and non-parametric tests were used to determine whether there were statistically significant differences among countries in terms of their disclosure scores, using as explanatory

¹⁶ The sample was structured by business sector as follows: diversified holdings (30 companies), banking and finance (26 companies), manufacturing (39 companies), utilities (five companies), natural resources (eight companies), property development (19 companies), and other services (18 companies).

variables in addition to country, assets, turnover, and debt-to-equity ratios. Multiple regression analysis was also applied in order to assess determinants of the extent of the level of disclosure. Their results revealed that statistically significant differences existed among companies in terms of their disclosure scores, asset sizes, turnover, and debt-equity ratios. They found that in terms of disclosure scores, Indonesian companies (46) disclosed significantly less than their Malaysian (87), Singaporean (103), and Thai counterpart companies (66). Philippine companies (62) disclosed significantly less than companies in Malaysia and Singapore, while Thai companies disclosed significantly less than those in Singapore. Overall, except for Malaysian companies, publicly-listed companies in all the other sample ASEAN countries in the study disclosed less, on average, than Singaporean companies. The result of the multiple regression model indicated that the effect of company size on disclosure level was positive and highly statistically significant (with $p \leq 0.001$). The researchers considered that these results strengthened the argument that size, measured in financial terms, is important in determining corporate disclosure levels regardless of a company's country of origin. Furthermore, they found that degree of financial leverage, industry group, foreign ownership, and country of origin (except in the case of Thailand), were statistically significant for level of disclosure. The explanatory variable 'international operations' (proxied by a dummy for companies with at least one overseas subsidiary) was found to be insignificant with respect to the level of disclosure. Overall, Craig and Diga observed that there was a high degree of *de jure* disclosure harmony in the ASEAN region, which they considered to stem from the preponderant influence of IASC-sanctioned accounting standards on national accounting standards issued by the domestic professional bodies in the region.

Hossain (2001) in an unpublished study empirically investigated the extent of disclosure of financial companies in Bangladesh together with associations between company size, profitability, and audit firm, with disclosure level. The study covered 25 banks comprising both public and private sector banks in Bangladesh. A total of 61 items of information, both voluntary and mandatory was included in the disclosure index. The approach to scoring items was dichotomous, an item scoring one if disclosed, and zero otherwise. Three research hypotheses were developed by considering independent variables and were tested with ordinary least square regression models. The results showed that size and profitability of the banks were statistically significant in determining their disclosure levels. However, the audit firm variable was not significant at conventional levels in the model. The study also included a questionnaire survey of user groups to assess the perceived importance of the various sections of bank annual reports. In this case, three user groups (shareholders, chartered accountants, and bank executives and directors) were identified and their views were sought on the relative importance of each of the 61 items selected. The perception of the users showed that the balance sheet was ranked first, followed by income statements. The study also reveals that banks are still behind legal requirements in respect of some items of information disclosable in annual reports, and that deficiencies still exist between International Accounting Standard 30 and the current basis of legal regulation in Bangladesh.

Haniffa and Cooke (2002) examined the relationships between a number of corporate governance, cultural, and firm-specific characteristics, and the extent of voluntary disclosure in the annual reports of a sample of Malaysian companies. A total of 65 items was selected and an unweighted disclosure index was used in the

study. The findings indicated a significant association between corporate governance and the extent of voluntary disclosure. In addition, one cultural factor (proportion of Malay directors on the board), was found to be significantly associated with the extent of voluntary disclosure.

Akhtaruddin (2005) reports the results of an empirical investigation of the extent of mandatory disclosure by 94 listed companies in Bangladesh. The study reports the results of the association between company-specific characteristics and mandatory disclosure of the sample companies. The results indicate that companies in general have not responded adequately to the mandatory disclosure requirements of regulatory bodies. It was found that companies, on average, disclosed 44% of the items of information, which leads to the conclusion that prevailing regulations are ineffective monitors of disclosure compliance by companies. Company age appears to be an insignificant factor for mandatory disclosure and there is little support for industry size as a predictor of mandatory disclosure except where size is measured by sales. Then it is marginally significant. Profitability was also found to have no effect on disclosure. Company status, i.e., whether a company is modern or traditional, also has no effect on mandatory disclosure.

Arcay and Vazquez's (2005) study examines the relationships among corporate characteristics, the governance structure of the firm, and its disclosure policy. Empirical evidence supporting this investigation has been gathered from a sample of Spanish firms listed on the Madrid Stock Exchange. This setting is of interest because of its low level of investor protection, high ownership concentration, and

poorly developed capital market. The results show that a firm's size, along with some mechanisms of corporate governance such as the proportion of independent directors on the board, the appointment of an audit committee, and directors' shareholdings and stock option plans, are positively related to voluntary disclosure. The study also observes that these governance practices are significantly influenced by cross-listings and by the ownership structure of the firm.

Ghazali and Weetman (2006) have examined factors influencing the extent of voluntary disclosure in annual reports of companies listed on the Kuala Lumpur Stock Exchange and found that, despite the changes in corporate governance in the wake of the 1997 financial crisis in South-East Asia, there has been no significant change in the factors associated with voluntary disclosure when compared with findings in Malaysia before the economic crisis, as observed by Haniffa and Cooke (2002). A total of 87 companies have been included in the study which used an unweighted disclosure index approach. The authors identified 53 items of voluntary information in the disclosure index. The study indicates that firm size and profitability show the expected positive association with voluntary disclosure. Moreover, the study reveals that traditional influences of director ownership and family control of the board of directors appear to have the strongest effect on voluntary disclosure.

Lopes and Rodrigues (2007) studies the determinants of disclosure level in the accounting for financial instruments of Portuguese listed companies. An index of disclosure based on IAS 32 and IAS 39 requirements was computed for each company. The analysis includes variables that capture intrinsic features of

Portuguese companies and institutional regulatory context, such as capital structure and characteristics of the corporate governance structure, within a contingency theory framework. Researchers could not find any significant influence of corporate governance structure or of financing structure. The study concludes that the disclosure degree is significantly related to size, type of auditor, listing status and economic sector. This research reveals areas for improvement of Portuguese companies' reporting practices and suggests areas for intervention of the Portuguese capital markets regulator in the context of mandatory IAS after 2005.

Curuk (2007) examined Turkish companies' level of compliance with the disclosure requirements of the EUFD over the years and then assessed whether companies' level of compliance had been influenced by their corporate characteristics, such as company size, listing status and industry type. The results of this study established that Turkish companies' level of compliance with the disclosure requirements of the EUFD were within the range of 30% to 85% over the years and increased significantly from one year to another throughout the selected period. The results of this study further revealed that Turkish companies' level of compliance with the required disclosure by the European Union had been influenced by their corporate characteristics. Significant association was found between listing status and a European Union corporate financial disclosure index for each of the five years covered in this study. On the other hand, the results of this study do not provide any evidence suggesting that Turkish companies' level of compliance was influenced by their size. Similarly, the results did not provide strong evidence to lead the author to conclude that industry type is one of the

important corporate characteristics of Turkish companies influencing their compliance with the European Union financial disclosure requirements.

Wang et al. (2008) examined empirically the determinants of voluntary disclosure in the annual reports of Chinese listed firms that issue both domestic and foreign shares and sought to determine if the cost of debt capital is related to the extent of voluntary disclosure. Findings revealed that the level of voluntary disclosure is positively related to the proportions of state ownership and of foreign ownership, firm performance (measured by return on equity), and reputation of the engaged auditor. There is no evidence, however, that companies benefit from extensive voluntary disclosure by having a lower cost of debt capital.

4.3 Literature Review of General Disclosure Studies of Indian Non-Financial Companies

Singhvi (1968) reported on the quality of corporate disclosure in the annual reports of 45 Indian listed corporations for the fiscal year ending between 31 December 1963 and 31 December 1965. He constructed a disclosure index similar to that in Cerf's study (1961). A total of 31 items was included in the disclosure index and independent variables including assets size, rate of return, earnings margin, choice of audit firm, type of management, and number of stockholders, were considered to test disclosure quality. Singhvi found that the relationship between the quality of disclosure and assets size, rate of return, earnings margin, and type of management, was positively strongly associated with disclosure levels.

As part of a detailed comparison of Indian and UK corporate financial reporting **Marston (1986)** studied the 30 largest Indian companies for the years 1982 and 1983 in order to draw comparisons with UK companies. In assessing the quality of Indian financial disclosure, she used a disclosure index used by Barrett (1976). A total of 17 items of information was chosen for the index and an index score was calculated for each company. The researcher converted the score to a percentage of the maximum possible score, taking into account the fact that some of the disclosure items were not applicable to certain companies. The results indicate that the mean index disclosure score for Indian companies was similar to that scored by a sample of 15 UK companies in the late 1960s. However, the level of disclosure in the UK was greater than in India at the time of survey. The researcher concluded that financial reporting in India was influenced by regulation and practice in the UK, adding. In a later but related study involving the same author **Marston and Robson (1997)** examined changes in financial reporting practice and regulation in India by studying disclosure in annual reports of 29 large Indian companies during the period from 1982-83 to 1989-90. The research instrument used was a disclosure index which included both voluntary and mandatory items. Seventeen items of Barrett's (1976) index were used because, in view of the authors "Indian financial reporting was relatively unsophisticated in 1982 and use of a more recently developed index with many disclosure items would doubtless have resulted in many zero scores" (p. 125). The results indicated that disclosure had increased between the two study periods and that in both periods disclosure was positively associated with company size with larger companies disclosing more than smaller companies in both periods.

Hossain (2000) contains an unpublished comparative analysis of financial reporting practices of three developing countries i.e. Bangladesh, India and Pakistan. The study was an attempt to examine empirically the association between a number of corporate attributes and levels of disclosure in the corporate annual reports of listed non-financial companies in three developing countries, India, Pakistan and Bangladesh. The perceived importance of a selected list of information items to four categories of users (i.e., bank loan officers, financial analysts, stock exchange members, and professional chartered accountants) was also examined as were the determinants of audit delay and audit fees ascertained. A disclosure index comprising 94 items of information, which were expected to be disclosed in corporate annual reports in the sample companies was developed. Both weighted and unweighted disclosure indexes were applied to the corporate annual reports for a sample of 78 Bangladeshi companies, 80 Indian companies and 103 Pakistani companies for the period 1992-1993. The association between the extent of disclosure and various corporate characteristics was examined using multiple linear regression models. It was hypothesised that for the sample companies in these three developing countries, size (assets and sales), profitability (rate of return on assets and net profit margin), debt-equity ratio, presence of debenture in debt, international links of the audit firm, industry type, subsidiaries of a multinational company, were positively associated with the extent of disclosure. A variable for assets-in-place was hypothesised to be inversely related to the extent of disclosure. It was found for the Bangladeshi companies that size (measured by total assets) and the proxy for subsidiary of a multinational company were significantly associated with the extent of disclosure. In the case of Pakistani companies, the results showed that assets-in-place, size (measured by total assets), and presence of debentures in debt structure, were

significantly associated with the extent of disclosure. The results for Indian companies showed that extent of disclosure was significantly related to the presence of debentures in debt structure, industry type, size, and rate of return on total assets. No significant differences were found for models comparing determinants of the weighted disclosure index and unweighted disclosure indices. The study revealed that the mean disclosure level of Pakistani companies was greater than that of Bangladeshi and Indian companies. The average disclosure level of Indian companies was found to be slightly less than the Pakistani companies. However, there was a significant difference between Indian and Pakistani companies and Bangladeshi companies; the mean disclosure level of Bangladeshi companies being much lower than the other two countries. Among 96 questionnaire items, the one-way ANOVA model for variance tests (Kruskal-Wallis) showed a high degree of consensus among Bangladeshi respondents (89.80%), Indian respondents (94.90%) and Pakistani respondents (90.82%). A majority of the respondents in India, Pakistan and Bangladesh perceived that the published annual reports in the sample country were not adequate or reliable.

In a separate analysis of audit delay it was found that for Indian, Bangladeshi and Pakistani sample companies, the variable of a subsidiary of a multinational company was significantly associated with audit delay. The results for Indian companies also showed that audit delay was significantly related to debt-equity ratio and size (total assets). The results of audit fee determinants suggest that for Bangladesh and India, only size (sales) was significantly positively associated with audit fee levels, while in the case of Pakistan, size (sales) and a subsidiary of a multinational company variable were found to be positively associated with audit fees. The auditee size

variable (sales) was consistent with the findings of other previous studies. However, the common regression model formulated in this study has provided significant deviation from the earlier studies. The study suggested that the audit services market in India, Pakistan and Bangladesh, may have some interesting characteristics but that further study is needed.

4.4 Literature Review of Studies of Banking Companies Disclosure

Having reviewed selected literature covering a range of time periods and countries and involving non-financial companies to establish main themes in the literature examining corporate disclosures using disclosure index approaches I now turn to a review of comparable literature which focuses specifically on banking companies. It should be noted that studies of banking companies are significantly less numerous than those of non-financial companies. The studies presented in the following section include some which cover issues out of the mainstream of the disclosure index studies already considered (eg corporate social responsibility) but are included for completeness sake.

Kahl and Belkaoui (1981) investigated the overall extent of disclosure by a sample of banks located in 18 countries. The researchers surveyed 70 commercial banks and selected one bank from each of six countries, i.e. Austria, Brazil, Holland, Italy, Norway, and Singapore, two banks from each of three countries, i.e. Australia, Denmark, and Finland, three banks from each of three countries, i.e. Sweden, Germany and Switzerland, 10 banks from each of two countries, i.e. Canada and Japan, with 11 banks sampled from the UK, and 16 banks from the USA. A disclosure index of 30 items of information was developed to measure disclosure

adequacy. A questionnaire survey was used with 15 business administration professors with knowledge of international financial reporting questioned in order to seek their views as a means of assigning weights to each item of information based on the respondents' perceptions of relative importance. Questionnaires were also sent to 50 bank financial analysts holding the professional designation CFA, on the assumption that the sample professors might not be a fully adequate proxy for the views of users of bank annual reports. The respondents were asked to rank each item of information on a five-point Likert scale from 0 to 4. Then the mean weights were used against items in bank annual reports. The researchers' findings focused on three aspects; firstly, the international differences in disclosure adequacy, secondly, the association of disclosure adequacy with banks' asset size, and thirdly, the relative importance of each information item. Their results indicated that the extent of disclosure was different among the countries examined, and that there was a positive relationship between size of the bank as measured by assets and the level of disclosure indicated (estimated by calculating the Spearman's rank correlation coefficient between the relative disclosure index score and the asset size ranking of each bank). Finally, the relative importance of each item of information was classified as high, moderate or low consensus so that priorities could be established in order to improve the banks' international financial reporting. For the latter part of the analysis, the researchers used a consensus score which was equal to the number of banks reporting each item divided by the number of banks for which a given information item was applicable.

Williams (2001) examined the relationship between firm and national level factors and the extent of *ex-priori* (i.e. in advance of) Y2K disclosure. The extent of Y2K

disclosure was measured from the 1997/98 fiscal-year annual reports of 145 commercial banks from the Asian-Pacific region. Findings indicated that the amount of Y2K disclosure amongst the sample population varied across national boundaries. Multiple regression results suggested a statistically significant association between several firm variables (organisational size and listing status), and national level variables (legal system, size of the equity market, level of economic development, cultural dimension of power distance, and the political and civil system) factors

Baumann and Nier (2003) developed a set of disclosure requirements related to Pillar 3 of Basel II (which sought to improve market participants' ability to assess a bank's value), using a unique dataset on close to 600 banks in 31 countries over the period of 1993-2000¹⁷. The dataset contains detailed information about the items that banks disclose in their annual accounts. They constructed a composite disclosure index that addressed disclosure at the bank level and then analysed each of the 17 elements into sub-indices of disclosure that made up the composite index, in order to investigate which if any items of banks' balance sheet disclosure were most beneficial from the point of view of the bank, and most useful for financial markets. The researchers approached the task from three different perspectives. Firstly, they investigated the relationship between the volatility of a bank's stock price and the amount of information the bank discloses to the market; secondly, they analysed the relationship between Tobin's Q and disclosure; and finally, they investigated whether disclosure increases the relationship between accounting information and the market's valuation of banks. The researchers used a number of different measures of

¹⁷ These countries were Australia, Argentina, Belgium, Brazil, Canada, Chile, Finland, France, Germany, Hong Kong, Indonesia, Ireland, Israel, Italy, Japan, Korea, Malaysia, the Netherlands, Norway, Poland, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, the UK, and the US.

disclosure. Firstly, they used the *Center for International Financial Analysis Research* (CIFAR) index of transparency; secondly, they used a bank-specific index of whether or not a bank is listed on a primary US stock exchange, and thirdly, they used a set of disclosure measures based on whether a bank discloses information on their chosen 17 categories of information (related to interest rate risk, credit risk, liquidity risk, market risk, and capital) in its annual accounts, as represented in the Bank Scope database. Their findings generally confirmed hypotheses that disclosure decreases stock volatility, increases market values, and increases the usefulness of company accounts in predicting valuations.

A country study by the **Gdansk Institute for Market Economics (2003)** provides limited data on bank disclosures from a study which focussed on corporate social responsibility in the Polish banking sector. The study was based on information disclosed and presented in web sites and annual reports by a sample of 31 Polish banks and indicated *inter alia* that the sample banks provided information on management board structure, including details of corporate governance structure, but did not present data concerning who was in charge of implementing and supervising the corporate social responsibility policy.

Helbok and Wagner (2003) examined financial institutions' disclosures on operational risk. Their study covered 142 banks from three regions: North America (USA and Canada), Asia (Japan and Hong Kong), and Europe (EU and Switzerland) from 1998 to 2001. In 2001 the Basel Committee on Banking Supervision released 'The New Basel Capital Accord' in which operational risk became the third risk category for which a capital charge and reporting requirements had to be applied (the

others being credit risk and market risk). Their analysis of the quantity of corporate financial disclosure on operational risk was approached by considering the importance given by financial institutions to operational risk relative to credit and market risk disclosure, and secondly by examining the quantity of operational risk disclosure undertaken and its change over time, attempting to control for changes in banks' risk reports as well as the complete annual report. The methodology applied by Helbok and Wagner to measure the quality of banks' disclosure on operational risk mainly followed the approach of Singhvi and Desai (1971). A disclosure index was created in order to evaluate the depth of disclosure on operational risk. The index consisted of 22 items in four categories (i.e. operational risk, definitions, risk management, and regulatory issues). Explanatory variables for the operational risk disclosure decision and the degree of disclosure in terms of both quality and quantity were used and included bank equity, a profitability ratio, net profit, and total assets. Data were retrieved from the Bankers' Almanac database. The researchers showed that both the quantity and the quality of banks' corporate financial disclosure on operational risk increased substantially from 1998 to 2001. There was additionally evidence that the ratio of equity capital/total assets is negatively related to the disclosure quantity and quality of banks indicating that institutions with a lower equity ratio choose a higher level of disclosure with respect to operational risk. Since disclosure on operational risk is an area where banks enjoy a large degree of choice the researchers argued that the evidence presented indicated that concerns about its bank equity ratio may lead a bank to a higher disclosure level.

McGrath's (2003) study delivers descriptive data on current practices in respect of social accounting disclosures by Australian banks in financial statements and other

web-based published reports. The paper limits the analysis of social accounting disclosure to the type of disclosure made and the choice of placement of the disclosure in published material as at August 2002. The study covered a sample of only nine banks and identified four major themes of corporate social reporting, i.e. natural environment, customers, human resources, and community, and also included a total of 17 items under the above four major themes. The study adopted a simplified content analysis approach, whereby a count of the incidence reported in each of the categories was undertaken, the intent being to capture a snapshot of the extent of reporting across the range of categories. The study revealed that the sample of Australian banks appeared to have taken on the concept of social responsibility in their reporting but that they followed no clear framework in content or format of reporting.

Spiegel and Yamori (2003) investigated the determinants of bad loan disclosure by Japanese “*shinkin*”¹⁸ banks in 1996 and 1997. This period is unique as disclosure was voluntary for *shinkin* banks during this time. The study revealed three interesting results. Firstly, banks with more serious bad loan problems were less likely to choose voluntary disclosure. Secondly, market forces, measured by the intensity of local competition did not appear to force banks to disclose more information and finally, larger banks were more likely disclose information, consistent with the corporate literature on disclosure.

¹⁸ *Shinkin* banks are cooperative financial institutions whose membership comprises local residents and small and medium-sized companies. Although in principle they limit their lending to their members their functions are much the same as those of normal commercial banks and they thus also deal with customers are not members, accepting deposits, providing exchange services, accepting various payments including those for public utilities, and engaging in over-the-counter sales of public bonds, investment trusts, and insurance. See Hussain, and Gunasekaran (2002) for some insights into their characteristics and operations.

Peterson and Hermans (2004) present a longitudinal study of social responsibility themes in US bank advertising for the years 1992, 1997, and 2002. Contents analysis was used to examine television commercials for socially responsible advertisements. The researchers defined nine activities of socially responsible commercial bank reporting as follows: consumerism, promoting civil rights and/or equal opportunity for minority groups, equal opportunity for women, the physical environment and ecology, patriotism, individual freedom, health and safety of the public, public education, and employee welfare. Their findings indicated that the communication of social responsibility in television commercials for banks increased by 7% over the time period covered by the study.

Ho and Taylor's (2007) study investigates triple bottom-line (TBL) disclosures of 50 of the largest US and Japanese companies including financial companies. Twenty disclosure criteria were developed for each of the TBL disclosure areas: economic, social, and environmental. Disclosure information was examined in annual reports, stand-alone reports, and special website reports. Regression analysis was used to examine empirically the determinants of TBL disclosure practice. The results indicate that, for total TBL disclosure (combining economic, social, and environmental categories), the extent of reporting was positively associated with larger size, lower profitability, lower liquidity, and for manufacturing firms. The authors concluded that the results for the total TBL disclosure are primarily driven by non-economic disclosures. The study also found that the extent of overall TBL reporting is higher for Japanese firms, with environmental disclosure being the key driver. The authors consider that their result could be attributed to the differences in

national cultures, the regulatory environment, and other institutional factors between the United States and Japan.

4.5 Literature Review of Studies of Indian Banking Companies Disclosure

The one extant academic study of disclosure by Indian banks is contained in Chipalkatti (2002) which examined the association between the nature and quality of annual report disclosures made by 17 Indian banks and independent variables capturing ownership, size, capital adequacy (as measured by capital adequacy ratios), profitability, leverage, and also representing aspects of banking market micro-structure such as the bid-ask spread and order depth. The researcher constructed a Bank Transparency Score (BTS) consisting of 90 items of information considering the recommendations of the Basel committee and IAS 30. The study showed that there was no significant association between the level of disclosure and the percentage of shares held by the government, and the percentage of shares held by foreign shareholders respectively. The results also indicated that larger banks provide more transparent disclosures. However, there was weak support to indicate that banks with higher capital adequacy ratios provide more transparent disclosures. And finally, there was no significant difference found in the disclosure scores of banks across profitability levels but banks with lower levels of leverage did have significantly higher disclosure scores.

4.6 Literature Review of Studies of Banking Companies Disclosure by Non-Academic Entities

In addition to academic researchers official bodies, consultancies and similar private sector entities with interests in banking have undertaken applied research activity directed the study of bank disclosures. Such studies are more numerous than those by academics discussed above and I review them in this section.

4.6.1 Basel and IOSCO (1996): ‘Survey of Disclosures about Trading and Derivatives Activities of Banks and Securities Firms’

In November 1995, the Basel Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commission (IOSCO) issued a report on their ‘*Survey of Disclosures about Trading and Derivatives Activities of Banks and Securities Firms*’. The report contained a survey of disclosures about trading and derivatives activities in 1994 annual reports of 67 banks and 12 securities firms as compared with 1993. It also contained a series of recommendations, both quantitative and qualitative, to stimulate further improvements in disclosure practices. These recommendations drew on the concepts developed in the *Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries*” (the Fisher report), released by the Euro-currency standing committee of the G-10 central banks ¹⁹ in September 1994 and “*The Framework for Supervisory Information about The Derivatives Activities of Banks and Securities Firms*”, released jointly by the Basel Committee on Banking Supervision and the IOSCO Technical committee in May 1995. This document

¹⁹ The G10 central banks are the Bank of Canada, Bank of England, Bank of France, Bank of Italy, Bank of Japan, Deutsche Bundesbank, Federal Reserve Board, National Bank of Belgium, Netherlands Bank, Sveriges Riksbank, and Swiss National Bank.

provided a follow-up survey that includes the 1995 disclosures about trading and derivatives activities of the banks covered in the November 1995 report.

4.6.2 Federal Reserve System (2000): 'Improving Public Disclosure in Banking'

Federal Reserve System (2000) is an internal staff study from the US Federal Reserve's study group on disclosure. The motivation stated for the reports is that as a banking regulatory agency the Federal Reserve has interests in strengthening the links between market discipline, transparency and bank supervision and as such wished to consider initiatives that might promote better financial disclosure in the banking industry. Thus, the report stated that "*improved disclosure would mean more transparency and more effective market discipline*" (p. 15). Accordingly, the report presented a set of such initiatives that it considered might reinforce the current forces shaping improved banking disclosures. The report lays the foundation for the initiatives by considering how market discipline could supplement supervision. The analysis suggested that greater reliance on private-sector oversight in banking can be consistent with the supervisory goals of limiting moral hazard and systemic risk and thus, accord with the public interest. The report also mentioned that banking agencies could improve disclosure and transparency directly through bank regulatory reports.

As part of the preparation of the report data was collected through a series of interviews conducted with securities analysts, institutional investors, rating agencies, clearing houses, and banks, in order to obtain opinion on current disclosure practices and the ways that new disclosures could enhance transparency and market discipline.

Three major themes emerged from the interviews. Firstly, changes in disclosure practices that were intended to improve understanding of market risk were considered to be less than fully successful. Secondly, most market participants wanted more information on credit risk. Thirdly, there was a distinct tension between banks' notions of proprietary information and users' beliefs that certain information should be disclosed. However, in the course of the interviews, several specific suggestions for improving disclosure were offered and these were as follows:

1. *Information on Concentrations of Risk:* Because concentrations are indicative of an institution's risk appetite, credit risk should be broken down by geographic region, industrial sector, largest classified assets, and top ten exposures (or perhaps a histogram of exposures as a percentage of capital).
2. *Internal Risk Ratings:* Asset quality should be described by internal risk ratings, and shifts between rating categories should be reported. To make this information useful, banks would also need to disclose the expected loss rates or probabilities of default associated with each category.
3. *Problem Loans:* More detail should be provided on problem loans. If the internal risk ratings of assets were disclosed, however, this additional detail would not be necessary.
4. *Lines of Business:* Segment reporting has become particularly important as banks have ventured into new businesses and this was considered to be an area for strengthening in reporting.

5. *Securitisations*: This area was highlighted as particularly problematic because banks do not typically reveal how much risk is retained or if positions are being hedged. One respondent described current disclosures as almost useless.
6. *Value at Risk (VAR) and Stress Tests*: Some respondents would like more detailed information on confidence intervals and correlations assumed in VAR calculations as well as the results of uniform stress tests.
7. *Tenure of Positions in the Trading Account*: Banks should disclose how long positions have been held on the balance sheet, and for positions that are old, an explanation of why the bank is holding them. Long tenure could be indicative of potential liquidity problems.
8. *Capital*: More extensive disclosures about market risk capital and internal capital allocations would be informative. Disclosures should relate capital to its uses, so that a bank reveals the riskiness of lines of business, concentrations of risk, and volatility of earnings.
9. *Interest Rate Risk*: Banks should provide some measure other than standard gap (i.e. difference between lending and borrowing rates).
10. *Funding Risk*: Bank disclosures generally lack information on contingency funding plans. Broker–dealer disclosures were considered by respondents to a good model in this area.

11. *Comparability*: Several respondents expressed a desire for more comparability to facilitate peer-group analysis. However, one analyst noted that meaningful and relevant data were preferable to comparable data.

12. *Fair Value*: According to analysts, disclosures that FASB requires on the fair value of financial instruments are useless and could be dropped to make room for new and more useful data.

This report and the issues for bank disclosures is interesting as an user-orientated evaluation of reporting by banks conducted in an advanced economy with a well-developed banking system and strong regulatory system. Although at some institutional distance from the Indian case at that time it is interesting to note that many of the issues raised in (1) to (12) above have come to be reflected in international regulations and recommendations for bank financial reporting.

4.6.3 Standard and Poor's Research on Disclosure

Standard and Poor the international credit rating agency and financial services company has undertaken systematic and comprehensive research on international corporate governance patterns that examined the practices of major public companies around the world (see <http://www.standardandpoors.com> for a generic source) which incorporates research on corporate reporting under the two related themes of transparency and disclosure. The key characteristics of Standard and Poor's transparency and disclosure measurements, rankings and methodology are

summarised in the following.²⁰ The focus of the Standard and Poor's approach is to calculate Corporate Governance Scores (CGS) which are based on an assessment of the qualitative aspects of corporate governance practices of a company with transparency and disclosure rankings that seek to provide disclosure complementary assessments for companies. The methodology is based on the application of 98 questions, each covering a corporate governance attribute, in three categories and 12 sub-categories and is designed to balance the conflicting requirements of the range of issues. Standard and Poor report that they consult leading academics and practitioners to maintain the comprehensiveness and practical usefulness of the rankings. Transparency and disclosure rankings are developed from an analysis of company annual reports and their sample covers companies in emerging markets (Asia, Latin America, Central and Eastern Europe, and Africa) as well as developed markets (Europe, developed Asia, and the US). The CGS scores seek to capture three broad categories of corporate governance: ownership structure and investor rights (28 attributes including for example the presence of a description of share classes, review of shareholders by type, and a description of the voting rights); financial transparency (35 attributes including for example the presence of a description of the company's accounting policy, consistency of company accounting with international accounting standards such as IAS or US GAAP, and efficiency indicators such as return of assets, or return on equity); and board structure and processes (35 attributes including for example the presence of a description of a list of board members, a list of board committees, a list of audit committee members, details of directors' remuneration and performance related pay, and related party transactions). Each question is evaluated on a dichotomous basis and rankings for

²⁰ See Standard and Poor (2002a), Patel, Balic, and Bwakira (2002), and Dallas et al (2004) for detailed discussions of methodology and results.

the three broad categories and an overall ranking is developed from the answers to individual questions. **Standard and Poor (2002b)** reports computed rankings for all S&P Global 1200 companies and the largest and most liquid S&P/IFCI companies and incorporating diverse markets and sectors. The S&P Global 1200 represents leading global companies and includes the S&P 500, 150 companies in Japan, and 350 companies in Europe. S&P/IFCI companies comprise 300 companies in emerging market. These 1,500 companies cover more than 40 markets and represent about 75% of the world's tradable market capitalization. Subsequent Stand and Poor studies have evaluated disclosures of banks in selected countries (see Standard and Poor's 2006a and 2006b for two recent examples).

4.6.4 Stradea Consulting (2003): 'Bank Risk Disclosure Survey 2003'

Stradea Consulting (www.stradea.com) is an independent management consulting firm in Finland specialising in finance and risk. This survey is based on a best practice risk disclosure database created by Stradea Consulting to support the development of risk management, reporting and disclosure of financial institutions. The survey sample consisted of 35 banks located in 13 Western European countries (UK, Ireland, Belgium, France, Spain, Denmark, Norway, Netherlands, Finland, Sweden, Germany, Austria and Switzerland). The criteria for selection of the sample were the provision of English version annual reports available for the year 2002. The study was conducted by using a methodology and grading framework developed by Stradea Consulting based on the actual best practice disclosure items found in annual reports, emerging regulatory requirements (e.g. BIS, IASB, and local regulators) and Stradea's experience and views on risk disclosure. The grading framework was divided into five main grading areas and each area was further

divided into several disclosure items, both qualitative and quantitative. The main five risk areas are:

- i. Risk strategy and shareholder value information,
- ii. Credit risk,
- iii. Market risk,
- iv. Operational risk, and
- v. Asset and liability management and liquidity risk.

The items within the risk areas are graded on a scale of 0 to 5, where 0 represents no information being disclosed regarding the item, and 5 corresponds to excellent, best practice level disclosure. The scores for the different items and areas were then weighted according to their perceived relative importance. The study revealed that most of the European banks were not too transparent regarding risks in their annual reports. One fifth of the surveyed banks had clearly inadequate risk disclosures and all the rest, except for three banks, could be classified as mediocre.

4.6.5 The Basel Committee on Banking Supervision (2003): 'Public Disclosures by Banks: Results of the 2001 Disclosure Survey'

Over the past several years, the Basel Committee's Transparency Group has conducted surveys of the public disclosure practices of internationally-active banks headquartered in its member countries. This applied research process is a component of the Basel Committee on Banking Supervision's ongoing efforts to promote effective market discipline in banking and capital markets through improved public disclosures. In general, the Committee encourages banks to publicly disclose both quantitative and qualitative information that will allow bank counter-parties and other financial market participants to make informed decisions regarding banks' risk

management practices and financial strength. More specifically, the Committee is proposing that market discipline should be enhanced in the context of the New Basel Capital Accord. The Committee has stated that a regime of enhanced disclosure relating to key elements of the New Basel Capital Accord - capital, risk exposure and assessment, and capital adequacy - will assist participants in effecting discipline in the capital markets. This framework of disclosure is proposed as the third pillar of the New Basel Capital Accord, along with minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2).

Three surveys on banking disclosure that have been undertaken by the Basel Committee in 1999, 2000 and 2001 respectively. The most recent survey was published in 2003 as *'Public Disclosures by Banks: Results of the 2001 Disclosure Survey'*. The Committee's intention with the survey of 2001 disclosure practices was stated as twofold: firstly, it gives an impression of the current scope of disclosure practice for comparison with the Committee's disclosure proposals in the New Basel Capital Accord. Secondly, it serves as a guide to the banking industry and standard setters by indicating the areas in which disclosure is relatively prevalent or lacking. The 2001 disclosure survey focused on the annual reports of 54 institutions representing a sample of internationally-active banks headquartered in the committee's member countries. The survey reviewed the disclosure of both quantitative information and the qualitative strategic and methodological disclosures that should enable the market to better evaluate banking organisations. It presented 104 questions in the survey addressing the quantitative and qualitative disclosure, and that were broken down into the following categories:

:

1. *Capital Structure*: disclosures that provide a view of the bank's level and composition of capital and the use of any hybrid capital instruments.
2. *Capital Adequacy*: disclosures that detail the bank's assessment of capital needs relative to its risks and business lines.
3. *Market Risk Internal Modelling*: disclosure of the type of market risk models used (e.g. VAR), the model's parameters, the bank's policies and procedures for bank testing and the disclosure of results from stress or scenario shock testing.
4. *Internal and External Ratings*: disclosures that provide insight into the bank's use of internal and external ratings in the bank's internal capital allocation process.
5. *Credit Risk Modelling*: disclosures regarding the type, methodology and validity of credit risk models employed.
6. *Securitisation Activities*: disclosures regarding the types of assets securitised, the bank's strategy and objectives, recourse provisions and accounting treatment.
7. *Credit Risk Allowances*: disclosures that assess the adequacy of allowances and help make informed conclusions on the bank's credit risk exposure.

8. *Credit Derivatives and other Credit Enhancements*: disclosures regarding the use of derivatives and other enhancements to mitigate, buy or sell, credit risk.
9. *Derivatives*: disclosures regarding the bank's strategy, business objectives, exposures and hedging uses of derivatives other than specific credit risk derivatives.
10. *Geographic and Business Line Diversification*: disclosures that reveal the nature and extent of any concentration in risk exposures.
11. *Accounting Policies*: a key area of disclosure that spans various activities.
12. *All Other Risks*: disclosures regarding litigation, operational and liquidity risks.

The survey revealed that many banks have continued to expand the extent of their disclosures. Overall, in 2001, banks disclosed 63% of the items included in the survey, up from 59% in 2000 and 57% in 1999. The Committee also encouraged banks to further enhance the transparency of their use of credit risk mitigation techniques, assets securitisation and internal ratings, given that disclosure in these areas will be qualifying criteria for the recognition or use of these techniques under the New Basel Capital Accord.

4.7 Conclusion

This chapter has reviewed studies of corporate disclosure by academics undertaken since the effect start of systematic study of disclosure using disclosure indices and

related methodology in 1961. I have considered this literature as it applies to the generality of companies and also to banking companies specifically. Research has examined disclosures in a wide range of countries and numerous studies have been directed at non-financial companies in those countries. However, I note that very limited systematic attention has been directed banking or other financial companies by academics using disclosure indices or related methodology and that, significantly for the research reported in this thesis, only one substantive academic study appears to be available for banking companies in India. The review in this chapter also included non-academic bodies both regulatory and commercial with interests in banking. These studies provide helpful insights into practitioners' views and banks' practices in disclosure. However, it should be noted that these studies are either focused on particular aspects of banks disclosures (eg risk) or part of more general interests (eg corporate governance) whereas academic studies are much more likely to be focused on financial reporting *per se*.

This literature review provides a basis for applying the methodology of disclosure indices to the relatively under-researched area of Indian banking companies. I note that studies have been directed using disclosure indices composed of voluntary information items, mandatory items, and voluntary and mandatory items together and that a range of corporate attributes have been used to explain variations and levels of disclosure. If an overview of the corporate attributes which have been employed by researchers is taken they maybe divided into three broad categories of corporate characteristics that can affect the degree of corporate disclosure and transparency within a market. The first category consists of the financial characteristics of the firm and this category has been used in studies from the earliest research on disclosure indices; the second comprises the firm's corporate governance characteristics and has

been developed as research on disclosure has progressed (Bushman, *et al.*, 2004); and the third consists of market discipline variables (Chipalkatti, 2002; Nier and Baumann, 2003; and Baumann and Nier, 2003) which is more characteristic of research, policy, applied and academic, which focuses on regulation of banks.. Therefore, based on the foregoing empirical evidence and related theory, this study will propose financial variables, corporate governance variables, and market discipline variables as possible determinants of the degree of corporate disclosure and transparency within the Indian banking market. I now turn to a consideration of the study's research methodology before going on in chapter eight to discuss the hypotheses which will be tested.

CHAPTER FIVE

THEORETICAL FRAMEWORK AND RESEARCH

METHODOLOGY

5.1 Introduction

This chapter presents the research paradigm which underpins this thesis and the methodology used in applying disclosure indices. The theoretical orientation of this research has also been informed by several theoretical approaches chiefly agency theory (see for example Watts and Zimmerman, 1978, 1990), stewardship theory (as in Donaldson 1990*a*, 1990*b*; Barney 1990), legitimacy theory (Carpenter and Feroz, 1992, and 2001; Guthrie and Parker, 1990; and Mezias, 1990), and stakeholder theory (as in Clarkson, 1995 and Guthrie et al, 2004). In addition, this chapter considers the study's research methodology which has been developed in light of the overall research objectives to be achieved and in relation to the literature review. In this connection, the role of disclosure, the consequences of economic and accounting research, the advantages and disadvantages of disclosure, the criteria for the selection of items, the development of the model, and other relevant aspects of the disclosure index approach have been discussed. The structure of this chapter is as follows: Section 5.2 discusses the research paradigm and theoretical orientation, Section 5.3 describes the role of disclosure, and Section 5.4 highlights some issues arising from economic and accounting research on disclosure. In Section 5.5, the chapter considers the advantages and disadvantages of disclosure in banking and this is followed by Section 5.6 which refers to the selection and collection of annual reports which comprised the data collection for this study. Section 5.7 discusses the

procedure relating to the selection of items to be included in the disclosure indices utilised in the research. Section 5.8 sets out the scoring methodologies for the disclosure indices. Sections 5.9 and 5.10 define and discuss the respective dependent and independent variables used in the regression analyses of determinants of variations in bank disclosure levels. The development of the regression models appears in Section 5.11, and finally Section 5.12 provides a summary and conclusion to the chapter.

5.2 Research Paradigm and Theoretical Orientation

It has been shown empirically that disclosure is a complex function of several factors: disclosure depends on both company-specific (internal) factors and external factors related to the environmental context of the company, which include, among others, culture, legal system, and institutional background. Indeed, stakeholders of companies demand information disclosure about the operations of the companies to get clear understanding which form the basis for their decision-making (Stolowy and Lebas, 2004 and Foster 1986). According to the International Accounting Standards Committee (1989), for the information provided by corporate entities to be useful for the decision-making process of the users, it must be understandable, relevant, reliable, comparable and timely. Prior research has utilised various theoretical models as foundation for understanding why disclosures are made to stakeholders including agency and legitimacy theories (Jensen and Meckling, 1976; Watts and Zimmerman, 1986 and Raffournier, 1995, Guthrie, et al., 2004). The theoretical foundation of this thesis is premised primarily on agency, and legitimacy theories. However, a discussion of stewardship and stockholder theories has been given

additional support in disclosure studies and these theories are also reflected in the work reported in the thesis. I now turn to a review of key issues in these various theoretical areas.

5.2.1 Agency Theory

Agency theory argues that shareholder interests require protection by separation of incumbency of roles of board chair and CEO. In other words, agency theory argues that in the modern corporation, in which share ownership is widely held and management roles are separated from ownership functions, managerial actions may depart from those required to maximise shareholder returns (Berle and Means 1932; Pratt and Zeckhauser 1985). In such cases, the owners are principals and the managers are agents and there is potential for agency losses which are measured by the extent to which returns to the residual claimants, the owners/principals, fall below what they would be if the owners/principals exercised direct control of the corporation (Jensen and Meckling 1976). Agency problems arise from two main sources, namely moral hazard²¹ and information asymmetry²² (together with its associated condition of adverse selection²³). In addition to identifying the agency problem inherent in agency relationships, agency theory seeks to specify mechanisms which might reduce agency loss (Eisenhardt 1989). These include incentive schemes for managers which reward them financially for maximising shareholder interests.

²¹ Moral hazard arises where an agent has incentives to undertake actions which are in the agent's best interests and are inappropriate from the point of view of the principal if the interests of the agent and the principal are not aligned.

²² Asymmetric information is present when one party to a transaction (typically the agent) has more or better information than the other party (typically the principal).

²³ Adverse selection refers to market processes in which inappropriate outcomes arise from information asymmetries between counter-parties (here agents and principals): thus "bad" agents (unskilled, unscrupulous, inefficient) may be more likely to be selected by principals than "good" agents; or badly-managed firms may be more likely to be invested in by principals than well-managed firms.

Such schemes typically include plans whereby senior executives obtain shares in the enterprise which they manage, perhaps at a reduced price, thus aligning the financial interests of executives with those of shareholders (Jensen and Meckling 1976). Moreover, Jensen and Meckling's (1976) positive agency theory provides a framework linking corporate disclosure behaviour to corporate governance. Corporate governance may be perceived as, *inter alia*, mechanisms that are introduced to control the agency problem and ensure that managers act in the interests of shareholders. In theory, the impact of internal corporate governance mechanisms on corporate disclosures may be complementary or substitutive. If it is complementary, agency theory predicts that a greater extent of disclosure is expected since the adoption of more governance mechanisms will strengthen the internal control of companies and provide an "intensive monitoring package" for the firm to reduce opportunistic behaviour by agents and information asymmetry between agents and principals (Leftwich, Watts and Zimmerman 1981; and Welker 1995). Managers are thus not likely to withhold information for their own benefits under such an intensive-monitoring environment and this may be argued to lead to improvements in disclosure comprehensiveness and the quality of financial statements. On the other hand, if the relationship is substitutive, companies will not tend to provide more disclosures for more governance mechanisms since one corporate governance mechanism may substitute for another one (Curuk, (2007).

Disclosure items may be determined by the relative importance placed on them by outsiders to the firm (i.e. financiers who do not belong to the board of directors, including individual shareholders) compared with the relative importance to insiders (financiers such as governments, families and banks). In countries where outsiders

are relatively important, there is a demand for more disclosure. Models that incorporate cultural and other environmental factors have been empirically tested by several researchers in either multi-country studies (Archambault and Archambault, 2003; Hussein, 1996; Jaggi and Low, 2000; Salter, 1998; Williams, 2004; Zarzeski, 1996) or single-country studies (Akhtaruddin, 2005; Chen and Jaggi, 2000; and Haniffa and Cooke, 2002). Chen and Jaggi (2000) study the influence of specific corporate governance factors present in East Asian companies (proportion of independent directors in the corporate board and family ownership) on disclosure. Haniffa and Cooke (2002) include corporate governance, cultural and company-specific factors as determinants of disclosure, arguing that (p. 317) “disclosure practice does not develop in a vacuum, but rather reflects the underlying environmental influences that affect managers and companies in different countries”. Within this framework, the agency theory can be applied to the Indian perspectives and Indian banking sector characteristic regarding ownership and control.

5.2.2 Stewardship Theory

Stewardship theory argues a view of managerial motivation alternative to agency theory (Donaldson 1990*a*, 1990*b*; Barney 1990). Stewardship theory argues that shareholder interests are maximised by shared incumbency roles for chair of board of directors and Chief Executive Officer (CEO) of the firm. The executive manager, under this theoretical view, far from being an opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets. Thus, stewardship theory holds that there is no inherent, general problem of executive motivation. Given the absence of an inner motivational problem among executives, there remains the question of how far executives can achieve good corporate performance to which

they (and owners) aspire. Thus, stewardship theory holds that performance variations arise from whether the structural situation in which the executive is located facilitates effective action by the executive. The issue becomes whether or not the organisation structure helps the executive to formulate and implement plans for high corporate performance (Donaldson 1985).

5.2.3 Legitimacy Theory

According to Van Der Lean (2004), legitimacy theory is a widely-utilised theory used to explain why corporate entities disclose relevant information to their stakeholders. The idea is that the purpose of corporations is to act on behalf of their stakeholders and as a requirement of this corporate entities should disclose both economic and social performance to these stakeholders so that the latter maybe well informed about the investments they have made and they should be able to compare corporate performance to their expectations about the companies in which they invest. In accordance with Legitimacy Theory, firms are perceived to undertake various actions to legitimise their operations in the public's eye. Thus, under this view effective organisations will react swiftly to changes in community concerns and priorities and behave and report accordingly. Managing legitimacy is seen as very much about managing societal perceptions. Firms may seek to manage the legitimisation process through various means. Meyer and Rowan (1977) argue that organisations integrate socially-legitimated rational elements in their formal structure in order to maximise their resources and survival capabilities.

Legitimacy Theory is closely related to the conception of the social contract. Social Contract Theory hypothesises that the cornerstones of morality are

uniform social accords that best serve the interests of those who make agreements. The theory posits that businesses are bound by a social contract in which firms agree to perform various socially desired actions in return for approval of its objectives and other rewards, and this ultimately guarantees its continued existence (Guthrie and Parker, 1989). Moreover, Legitimacy Theory asserts that

' ... organisations continually seek to ensure that they operate within the bounds and norms of their respective societies, that is, they attempt to ensure that their activities are perceived by outside parties as being 'legitimate ... ' (Deegan, 2000, p. 253).

Legitimacy theory is essentially a systems-oriented theory whereby organisations are viewed as components of the larger social environment within which the organisations exist (Gray, Owen and Adams, 1996; Woodward, Edwards and Birkin, 1996). Thus, companies try to manage their legitimacy because it

“ ... helps to ensure the continued inflow of capital, labour and customers necessary for viability ... It also forestalls regulatory activities by the state that might occur in the absence of legitimacy ... and pre-empts product boycotts or other disruptive actions by external parties ... By mitigating these potential problems, organizational legitimacy provides managers with a degree of autonomy to decide how and where business will be conducted” (Neu et al., 1998, p. 265).

Societal expectations which institute the super-ordinate system which establishes the legitimacy environment may be deemed to encompass economic, environmental and social factor-relationships (Elkington, 1997). Through corporate disclosure, organisations communicate to all their stakeholders that they are abiding with the terms of the social contract and thus achieve the legitimacy necessary for their continued survival.

5.2.4 Stakeholder Theory

Stakeholder theory argues that an organisation's management will engage in, and report on, activities that are expected by the organisation's shareholders (Clarkson, 1995; Guthrie et al, 2004) and that shareholders have a right to be provided with information about how the organisation's activities affect them (Deegan, 2000; Vergauwen and van Alem, 2005). In particular, less powerful shareholders need to be compensated for the information that larger and more powerful shareholders have obtained in private meetings (Holland, 2001). Therefore, shareholders require information about important corporate assets, and high levels of expectations would necessitate high levels of voluntary disclosure in annual reports.

Stakeholder Theory explicitly considers the expectations impact of the different stakeholder groups within society upon corporate disclosure policies. Incorporating elements of the US Trueblood Report (1973), Woodward (1993) explains that the larger public have stakeholder communities which consist of the following interest groups – owners of human resources, owners, non-equity suppliers of funds, suppliers of goods and services, customers, political interest, the general public and

the physical environment.²⁴ Under the managerial branch of Stakeholder Theory, the central thesis that emerges is that corporate disclosure is a management tool for managing the informational needs of the various (powerful) stakeholder groups. Managers use information to manage or manipulate the most powerful stakeholders in order to gain their support which is required for survival (Gray, Owen and Adams, 1996).

5.3 The Role of Disclosure

In major developed countries, regulation of financial institutions, in particular banks, is carried out by a combination of three approaches (Gray, 1996). The first involves the imposition of minimum prudential standards and the monitoring of compliance. The second involves the supervisor assessing, on the basis of qualitative and quantitative information supplied by banks, the quality of a bank's internal risk-management procedures. The third approach is to rely on disclosure of information to the public. The first two approaches are concerned with minimising the likelihood of institutional insolvency, although they recognise that this eventuality cannot be eliminated. The third is designed to assist consumer and investor choice, and to introduce an element of market discipline on institutions.

Economic theory suggests that information and incentive problems impede the efficient allocation of resources and that disclosure mitigates these problems (Healy and Palepu, 2001). The optimal allocation of savings to investment opportunities is a complicated matching process because firms providing investment opportunities have better information about the value of the firm than investors and firms'

²⁴ Equivalent arguments may be supported by reference to the UK Corporate Report.

communications are not completely credible because investors know firms have incentives to inflate value (Healy and Palepu, 2001). Thus, information asymmetry inhibits investment, thereby reducing liquidity and increasing the cost of capital (Verrecchia, 2001). Healy and Palepu (2001) suggest three solutions to the problem; providing management incentives to make full disclosure, the use of effective information intermediaries (financial analysts or rating agencies) who engage in private information production, and/or regulations that require managers to fully disclose their information.

According to Basel Committee on Banking Supervision (1998) a sound and well-managed bank should, in theory, benefit when it provides comprehensive, accurate, relevant and timely information on its financial condition and performance, and ability to manage and control risks. Such a bank should be able to access capital markets more efficiently than similar institutions that do not provide adequate disclosures. Therefore, adequate public disclosure facilitates a more efficient allocation of capital between banks since it helps the market to accurately assess and compare the risk and return prospects of individual banks.

5.4 Issues in Economic and Accounting Research on Disclosure

The disclosure-related literature has developed into a distinct branch of economic and accounting research (Frolov, 2004). Following a taxonomy suggested by Verrecchia (2001), three major research problems confronted by the literature may be distinguished:

- a) whether information disclosure is economically efficient in general;
- b) what is the effect of information disclosure on the aggregate behaviour of economic agents;
- c) what are the circumstances surrounding the decision to make private information public.

The first research issue seeks answers to the general question about whether information disclosure is economically efficient in general. There are groups of theorists suggesting two possible explanations for the *per se* desirability of information disclosure.²⁵ On the one hand, Kunkel (1982) shows that in an economy including both production and exchange, information disclosure may be preferred because altered production plans lead to more efficient allocation of resources across time and firms. On the other hand, Diamond (1985) suggests that in a pure exchange setting with costly acquisition of private information, the (costless) information disclosure is desirable because it will allow investors to economise on the acquisition of private information and make them better off, despite adverse risk-sharing effects. The latter approach has been more popular, developing into theoretical constructs with testable predictions (Frolov, 2004). However, a number of empirical studies have supported the prediction of the negative relation between disclosure and the cost of capital (Frankel *et al.*, 1995; Welker, 1995; Botosan, 1997; Healy *et al.*, 1999; Lang and Lundholm, 2000; and Botosan and Plumlee, 2002), thus establishing an important link between information disclosure and economic efficiency.

²⁵ Early literature on disclosure suggested that since under the simultaneous assumptions of pure exchange and perfect market competition, information disclosure may lead only to wealth redistribution among agents, this leaves no place for disclosure-based (weak) Pareto improvements (Verrecchia, 2001).

The second research issue in disclosure-related research focuses on the effect of information disclosure on the aggregate behaviour of economic agents, and in particular on the behaviour of financial market aggregates like stock prices and trading volume. The literature attempts to explain empirically-observed phenomena in the association between information disclosure and market responses, using plausible assumptions about diversity among market participants²⁶. Theorists have modelled the effects of disclosure when investors are diversely informed (e.g., Lintner, 1969; Kim and Verrecchia, 1991), when investors interpret disclosure in diverse ways (e.g., Dontoh and Ronen, 1993; Harris and Raviv, 1995), as well as when investors incorporate disclosure in their beliefs in diverse ways, both rational and heuristic (e.g., DeLong *et al.*, 1990; Palomino, 1996; and Kyle and Wang, 1997).

The finally disclosure research issue directs the literature to devote attention to the circumstances surrounding the decision to make private information public. It is a standard argument here that management's decision about whether to disclose information is based upon weighing the expected costs and benefits of making the information public (Frolov, 2004). The available literature has suggested many ways in which a firm or its management can be benefited from improved disclosure. This explanation may turn to the problem of adverse selection under asymmetric information. Myers and Majluf (1984) pointed out that if a firm is about to issue equity or public debt to the market, it has an incentive to disclose its superior information. Moreover, as Frolov (2004) comments, since rational investors interpret the withholding of information on a financial asset as information that is unfavourable about the asset's value or quality, they will discount the asset unless the

²⁶ For an elaboration on this direction of research see e.g., Verrecchia (2001).

information is revealed, and the existing shareholders of the firm will be better off if they credibly disclose the information before the firm accesses the capital market. There are empirically broad supports for the hypotheses. For example, direct evidence that firms increase the intensity of their disclosure efforts before offering public debt and equity, has been obtained by Lang and Lundholm (1993, 1996), Frankel *et al.*, (1995), Healy *et al.*, (1999), etc. The list of other suggested explanations of voluntary information disclosure includes motives related to institutional factors and signalling to the market.²⁷

The economic and accounting literature provides arguments about why information disclosure may be costly for firms. The research refers to the problem of proprietary costs. Verrecchia (1983), Darrough and Stoughton (1990), and Newman and Sansing (1993), hypothesise that firms' decisions to disclose information to investors are influenced by concern that such disclosures can damage their competitive position in product markets. Moreover, another argument is the costs associated with uncertainty about the quality of information being disclosed. The uncertainty works as a disclosure cost because it creates doubt in the minds of the uninformed and, thereby, reduces the benefits of information disclosure from ameliorating the adverse-selection problem (Frolov, 2004). Different types of theoretical constructs pertaining to uncertainty suggest that firms (or managers) are better off if they conceal some discretionary information (Dye, 1985), Teoh and Hwang, 1991, Nagar, 1999). In

²⁷ As surveyed by Healy and Palepu (2001), the management of firms may also be interested in improved disclosure since it reduces the risk of premature resignation because of poor stock performance (e.g., studies by Palepu, 1986; DeAnglo, 1988; Warner et al, 1988, Morck et al, 1990) and the cost of litigation (Skinner, 1994), increases the value of the management's stock options (Noe, 1999; Aboody and Kasznik, 2000; Miller and Piotroski, 2000), and facilitates more signals to the market about the superior strategic management abilities of the COEs (Trueman, 1986).

addition, the literature again resorts to the institutional factors to explain high (corporate and personal) costs of disclosing unfavourable or forward-looking information.

It needs to be questioned whether the hypotheses advanced for the benefits of increased disclosure in academic literature are generally robust with respect to the actual motives why firms' management and market participants favour (or oppose) disclosure. A study by PricewaterhouseCoopers (Eccles *et al.*, 2001) reports that in an opinion poll of CEOs, traders, and analysts, the most frequently stated benefit of improved corporate disclosure was reported as the increased credibility of management. Other frequent (positive) responses for the benefits of increased disclosure also include increased number of long-term investors, improved access to new capital, increased analyst following, and increased share value. According to Frolov (2004) firms' managements perceive disclosure, on average, less favourably than do the market participants, because CEOs either do not expect the market to reward them for the improved disclosure (thus "the market looks only at earnings", "the market won't be satisfied even if given additional information", and "nobody believes disclosed figures"), or worry about additional costs they may incur if disclosed further (thus "share value would decline if there are bad result figures", and "competitive disadvantage if competitors knew the information").

The above discussion shows that while information disclosure may be socially desirable (Frolov, 2004; Diamond, 1985), the interplay between its benefits and costs may lead to partial or no disclosure, and one should, therefore, ask whether the disclosure should be voluntary or mandatory. Indeed, the economic and accounting

literature has asserted that in the view of informational asymmetry, (costless) disclosure of private information brings general gains in economic efficiency. However, the size of the gains and the ultimate effect on financial prices may vary considerably depending on the 'informativeness' of disclosed information and on the ways the information is disseminated and used.

Thus, it cannot automatically be assumed that for management increased disclosures through voluntary presentation of non-mandated information will be seen as desirable. Neither should it be assumed that managers will necessarily disclose all information mandated by regulators in the absence of strong regulatory regimes or sanction. This suggests that *a priori* there are important questions to ask of disclosure by Indian banks of both voluntary and mandated financial information. However, to develop our thinking on these matters I shall next consider whether banking presents any particular issues on disclosure.

5.5 Advantages and Disadvantages of Disclosure in Banking

The problem of disclosure of information has been noted by both policy makers (as set out in previous chapters) and researchers as of considerable relevance to the banking industry. Frolov (2004) identifies three main reasons for judged importance namely: first, the very nature of the banking business, second that banks actively issue stocks and public debt to investors, and third put the proceeds of stock issues, public debt, and customers' deposits mostly in assets with value uncertain to outside investors. Thus, the nature of the banking business is such that it much depends on deposits and advances, and the value of a bank's assets is uncertain because these are financial assets, which allow quick and easy trading, and thus enable the banks to

silently shift risk to the investors. Regarding banking activity, the bank assets are mostly opaque non-tradable loans, for the banks specialise in lending to borrowers of publicly unknown quality by gathering and producing information about the borrowers and using it for their screening and monitoring²⁸. The opaque nature of bank assets makes the argument by Diamond (1985) that disclosure is a socially desirable way to economise on the costly acquisition of information, especially acute, and explains why the issue of bank disclosure may be socially important. While investing in opaque illiquid loans, the banks use high leverage and finance their activities mostly with short-term debt (deposits). This creates the possibility of bank runs that may be a purely psychological phenomenon but still inflict social costs (Diamond and Dybvig, 1983). Since it is the depositors' uncertainty about the financial condition of their bank that drives them to run, disclosing information about the bank can prevent socially undesirable runs²⁹.

Finally regarding the third issue, disclosure may exercise a welfare-improving effect by limiting excessive risk-taking by banking institutions. Asset opacity is in the nature of the banking business, and it amplifies the banks' incentive to moral hazard, creating the conditions for their profiting at the expense of uninformed creditors. However, better bank disclosure can curtail the moral hazard both ex-ante and ex-post (Frolov, 2004). With the ex-ante effect, the funding cost of risky institutions increases as potential depositors and other creditors appreciate the banks' (disclosed)

²⁸ For instance, the empirical studies by Morgan (1997) and Flannery *et al.* (2004) find that rating agencies and capital market participants view banks more risky the higher their asset concentration on loans.

²⁹ Furthermore, if a bank run is driven not by psychology but by poor financial performance of the bank, it will lead to a socially desirable reallocation of banking capital to more efficient institutions (Jacklin and Bhattacharya, 1988; and Chari and Jagannathan, 1988).

financial condition. In addition ex-post, the banks' risk-taking is disciplined by costs inflicted by en mass withdrawals of deposits from the risky institutions or simply by a threat of a run on them (Calomiris and Khan, 1991). The market discipline effect has received sound empirical support in Park (1995), Billet *et al.* (1998), Martinez and Schmukler (2001). The empirical evidence can also be viewed in favour of improved bank disclosure, since effective market discipline depends on market participants' having information about the risk and financial condition of banking organisations.

The lack of incentives to voluntary disclosure in banking brings attention to the issue of mandatory disclosure requirements. Over the past two decades, banking disclosure regulation has been gradually strengthened in quantitative requirements and widened in scope of disclosed information. However, mandatory disclosure has its strengths and weaknesses. On the strong side, the users of the disclosed information – securities analysts, rating agencies, and institutional investors – stress the importance of banking regulatory reports in preparing their evaluations, for the reports allow direct comparison among banks when comparability is lacking in annual reports (Study Group on Disclosure, 2000, discussed under Federal Reserve Board in chapter 6 above). On the weak side, it is stressed that the fixed format of the regulatory disclosures does not easily accommodate new issues as they develop. Another weakness is that in setting disclosure requirements, the regulators cannot rely on market consensus on information needed: Disclosing banks and the users of information are deeply divided on where to demarcate between proprietary and non-proprietary information, and as a result it is typically unclear whether or not given disclosure requirements are good and efficient (Frolov, 2004). Indeed, keeping in

mind the fact that with the safety net protection in place, banks lack incentives to voluntarily disclose information, regulators have to set up some public disclosure regime despite the uncertainty about its quality.

Therefore, I may conclude that disclosure of both mandatory and voluntary items by banks is theoretically and empirically justifiable and is desirable in order to establish confidence in banks on the part of investors, depositors, borrowers, and society at large. With this justification I turn to the description of the research undertaken in this study on Indian banks and their financial and other disclosure activities.

5.6 Sample Selection and Collection of Annual Reports

The study reported in this thesis takes as a sample the Indian public and private sector banks listed on the Bombay Stock Exchange (BSE), and the National Stock Exchange (NSE). Foreign banks and regional rural banks are excluded from the sample as they are not listed on the above exchanges. Thus, the sample of this study consists of 38 banks, comprising both public and private banks. As on 30 June 2004 the total number of Indian banks was 58, of which 27 were public and 31 private. A sample of 38 (65%) of these banks has been selected on the basis of listing status. As already indicated, the study considered only those banks listed either on the BSE or/and the NSE. Adopting this criterion, 38 banks were eligible for consideration, these being 13 and 25 public and private sector banks respectively. The study covered the year 2002-03 and the annual reports of that year were collected. The banks identified as the sample for this study are listed in Table 5.1.

The list of the banking companies was found in the Annual Report of the Reserve Bank of India. The researcher collected the name and address of each bank and sent letters and emails from the UK to representatives at the banks' Indian head offices of the proposed sample asking for a copy of their annual reports for the year 2002-03. As a result of this process, only 12 annual reports from the 38 banks which were approached were received as a first response. Despite follow-up contacts and direct personal contacts from the researcher no further direct responses were received by from the banks to the researcher. As a consequence, the researcher investigated the availability of vendors or service providers that might provide annual reports on a commission basis or fee basis as a commercial service. A commercial service provider who supplies copies of annual reports was identified at www.sansco.net. This supplier was approached and for a fee supplied all the sample companies' annual reports in PDF format on CD for the study year.

Table 5.1 Sample Banks

Public Sector Banks	Private Sector Banks
1. Allahabad Bank	19. Bank of Rajasthan Ltd.
2. Andhra Bank	20. City Union Bank Ltd.
3. Bank of Baroda	21. Dhanalakshmi Bank Ltd.
4. Bank of India	22. Federal Bank Ltd.
5. Canara Bank	23. ING Vysya Bank Ltd.
6. Corporation Bank	24. Jammu and Kashmir Bank Ltd.
7. Dena Bank	25. Karnataka Bank Ltd.
8. Indian Overseas Bank	26. Karur Vysya Bank Ltd.13
9. Oriental Bank of Commerce	27. Lakshmi Vilas Bank Ltd.
10. Punjab National Bank	28. South Indian Bank Ltd.
11. Syndicate Bank	29. United Western Bank Ltd.
12. Union Bank of India	30. Bank of Punjab Ltd.
13. Vijaya Bank	31. Centurion Bank Ltd.
14. State Bank of India	32. Global Trust Bank Ltd.
15. State Bank of Bikaner and Jaipur	33. HDFC Bank Ltd.
16. State Bank of Indore	34. ICICI Bank Ltd.
17. State Bank of Mysore	35. IDBI Bank Ltd.
18. State Bank of Travancore	36. IndusInd Bank Ltd.
	37. Kotak Mahindra Bank Ltd.
	38. UTI Bank Ltd.

5.7 Selection of Items of Information Included in the Disclosure Index

The prime task of the present research was to develop a suitable disclosure index by considering the items of information that are mandatory and/or voluntary, which may

be disclosed in the annual reports of the sample of financial companies in India. The selection of items included in the disclosure index is a major task in the construction of any disclosure index research study (Marston and Shrivies, 1991). As our literature review as indicated there is no generally accepted theory or model regarding user information needs. An item of information may have a great importance to a particular interested user group while it might have little importance to other user groups. The researcher included items of information having potential interest to the three types of user groups in India, i.e. shareholders, professional accountants, and bank executives and directors. Thus, the items of information included in the disclosure index have been considered from the viewpoint of a general-purpose context rather than a specific user group context.

In considering the potential items of information, the researcher first identified items as mandatory and voluntary. Mandatory items of information are those items of information which it is a legal requirement to disclose in annual reports by the respective Acts and Ordinances governing Indian banks. In contrast, voluntary items of information are those items of information that are not mandated by the Acts and Ordinances, but are rather suggested as good practice by the regulatory authority, academic literature, or international financial organisations. Voluntary disclosure is measured by the amount and detail of non-mandatory information that is contained in the annual report. Such disclosures can be defined as “disclosures in excess of requirements, representing free choices on the part of company managements to provide accounting and other information deemed relevant to the decision needs of users of their annual reports” (Meek *et al.*, 1995, p. 555).

The selection process of the both mandatory and voluntary items of information is now discussed.

5.7.1 Mandatory Items of Information

Disclosure is the communication of economic information, whether financial or non-financial, quantitative or otherwise, concerning a company's financial position and performance. It is described as mandatory if companies are obliged under a disclosure regulatory regime to disclose insofar as they are applicable to them (Owusu-Ansah, 1998). Disclosure implies the presentation of a minimum amount of information in corporate reports, sufficient to permit a reasonable evaluation of the relative merits and risks of listed securities (Griffin and Williams, 1960; and Belkaoui, 1985). In the present study, the disclosure of applicable mandated information items is defined as the minimum standard of disclosure that regulatory bodies in India expect of the sample companies. Conceptually, disclosure of information in corporate financial reports is considered 'adequate' if it is relevant to the needs of users, capable of fulfilling those needs, and timely released (Buzby, 1974; and Wallace, 1987). In other words, adequate disclosure in a corporate financial report is a function of the quantity and quality of information disclosed therein, the form in which it is presented and how frequently and timely this is publicly reported (Owusu-Ansah, 1998). The present study focuses firstly only on adequate disclosure in the context of the extent to which mandated applicable information items is presented in annual reports of the sampled banking companies. Adequate disclosure is, thus, operationalised in the present study as the number of mandated applicable information items that a listed company discloses, and the degree of intensity by which it discloses those items in its annual report. A wider

view of adequacy may be taken later when the levels of voluntary disclosure are considered and related to mandatory disclosures.

The following criteria were applied to both quantitative and qualitative items in the annual reports of the sample banks to select the items of mandatory items of information.

1. Items of information which are mandatory by the Banking Companies Act, 1949. In this case, Balance Sheet and Profit and Loss Account items have been identified as mandatory. The researcher found that 13 items in the Balance Sheet and seven items in the Profit and Loss account are mandatory.
2. A total of five items of information identified as mandatory under the heading Directors' Report in the Annual Report as mentioned in the Company Act 1956.
3. Items identified as mandatory in Clause 49 of the listing agreement of the relevant stock exchanges on which the sample companies were listed. In 2000, the Securities and Exchange Board of India (SEBI), a regulatory body of the capital market, made it mandatory for all listed firms to report 'Corporate Governance' in a separate section in annual reports. In this category, 44 items are identified as mandatory. This mandatory requirement motivates a separate strand of the empirical analysis reported later in the thesis which focuses on corporate governance disclosures in addition to the wider analysis of mandatory and voluntary disclosure.

4. According to Companies Act legislation there must be a separate section in the directors' report concerning the Management Discussion and Analysis contained in the annual reports.
5. Under the RBI guidelines, 24 items of information are identified as mandatory.

Using the above criteria, the total number of items of mandatory information was identified as 101. These are listed in Appendix 7 below.

5.7.2 Voluntary Items of information

The issue of voluntary disclosure has attracted the attention of researchers in accounting, economics and finance as noted above. Seminal findings in this area introduced by Grossman (1981) and Milgrom (1981) were that in a market with rational expectations and costless disclosure, firms will voluntarily disclose all information. Voluntary disclosure and its determinants have been identified as an important research area in financial reporting since the 1970s. As discussed above previous studies on the determinants of voluntary disclosure have been conducted mainly in the US and other developed countries (e.g., Malone *et al.*, 1993; Schadewitz, 1994; Raffournier, 1995; and Lang and Lundholm, 1996).

Clearly, the selection of voluntary items is a subjective judgment. Moreover, such selection depends on the nature and context of the industry and the country context (e.g., what industrial sector or sectors is being considered and whether the companies are in a developing or developed country). As we saw in our literature review while

there is extensive literature focussing on disclosures of non-financial companies, including voluntary disclosure, research addressing the disclosure by financial companies, including their voluntary disclosures is much less numerous. Some studies have considered the social reporting of financial companies (including Islamic banks), and the international financial institutions (eg the IMF, and World Bank) have also stressed the importance of transparency and disclosure by financial companies. Additionally, other organisations, both public and private, like the US FSAB, US Federal Reserve System, the International Accounting Standards Committee/International Accounting Standards Board, and Standard and Poor's have published guidelines regarding the disclosure of voluntary items. The researcher reviewed recommendations from the following sources to arrive at the selection of a list of voluntary items of information to be included in the disclosure index:

1. Literature related to studies focused on voluntary disclosure;
2. Academic literature especially focused on Indian companies in line with the present research objectives;
3. Academic literature concerned with developed and developing countries;
4. Academic literature focused on financial companies;
5. International financial institutions' recommendations;
6. Other institutions' published works;
7. Disclosure for financial institutions as required by International Accounting Standard 30;
8. RBI guidelines;
9. US Securities and Exchange Commission guidelines.

After investigating all the above data sources, 83 items of voluntary information were identified as relevant for disclosure in the annual reports of banking institutions in India. These 83 items were then grouped to produce 14 categories, containing between 2 and 11 items each. Table 5.2 shows the 14 categories, and identifies some of their sources. It is not intended to be a fully comprehensive record of all the sources which influenced the selection of each individual item as this was a complex process of inter-action and judgement but it instead it serves as an indication of the methodology adopted and a justification based on at least one source. The total list of the 83 voluntary items is presented in Appendix 5.

Table 5.2 Items Included in the Voluntary Disclosure Index and an Indicative List of their Sources

	Categories of disclosure	Number of items	Evidence for inclusion
1	Background about the bank	06	Kahl and Belkaoui (1981); Ahmed and Nicholls (1994); Singhvi (1968)
2	Corporate strategies	03	Chau and Gray, 2002
3	Corporate governance	11	Haniffa and Cooke , 2002; S & P, 2002; BASEL, 1999
4	Financial performance	13	Cooke, 1991, 1992; BASEL, 1998
5	General risk management	07	BASEL, 1999; Chipalkatti (2002)
6	Credit risk exposure	08	BASEL, 1999; Chipalkatti (2002)
7	Market risk exposure	04	BASEL, 1999; Chipalkatti (2002)
8	Interest rate risk	03	BASEL, 1999; Chipalkatti (2002)
9	Currency risk	03	BASEL,1999; Chipalkatti (2002)
10	Liquidity risk exposure	03	BASEL, 1999; Chipalkatti (2002)
11	Accounting policy review	02	BASEL, 1998
12	Corporate social disclosure	04	McGrath (2003), Peterson and Hermans (2004)
13	Key non-financial statistics	08	RBI guidelines, IAS 30, Craig and Diga, (1998)
14	Other	08	Hossain (2001); Kahl and Belkaoui (1981)

Source: Literature review by the researcher

5.8 Scoring of the Disclosure Index

Several approaches are available when developing a scoring scheme to determine the disclosure level of annual reports, and usually both a weighted disclosure index and an unweighted disclosure index have been used by researchers. Researchers such as

Wallace (1987), Cooke (1991 and 1992), Karim (1995), Hossain *et al.* (1994), Ahmed and Nicholls (1994), and Hossain (1999), adopted a dichotomous procedure in which an item scores one if disclosed and zero if not disclosed and this approach is conventionally termed the unweighted approach. The weighted disclosure approach (used by, for example Curtis, 1979; Barrett, 1976 and 1977; and Marston, 1986), involves the application of weights above zero but less than one, to items of information which are disclosed (zero is the weight for non-disclosure). In some cases, researchers' subjective judgment is applied to determine the weight of individual items of information. On the other hand, Buzby (1974), Stanga (1979), and Firth (1979), used average weights derived from questionnaire surveys of users' perceptions of the importance of disclosure items. Previous experiences also show that the use of unweighted and weighted scores for the items disclosed in the annual reports and accounts of companies can make little or no difference to the findings (Coombs and Tayib, 1998). Firth (1980), for example, noted that unweighted and weighted scores showed similar results.

Cooke and Wallace (1989, p.51), Marston and Shrivs (1991, p.197), Malone *et al.* (1993, p.257) and Botosan (1997, p.325), have all reported that the level of disclosure is an abstract concept which is not amenable to precise measurement and instead, contend that a disclosure index can be used to derive a surrogate measure for the amount of information disclosed by a company in its annual report. The application of an index to measure overall disclosure is widely deemed to be appropriate by researchers as contracting constituents (e.g. shareholders) require a myriad of information (e.g. investment performance, profit performance and so on)

in order to monitor contractual compliance ex post. Barnea *et al.* (1989, p. 249)

report that

“ ... detailed information is required for an effective ex post monitoring of management performance... [and that] ... If accounting numbers are produced in sufficient detail they allow for more accurate measurement of risk ... in an ex ante sense.”

.Moreover, unweighted disclosure indices have been commonly applied in contracting theory-based disclosure studies reported in the academic accounting literature (i.e. Chow and Wong-Boren, 1987, pp. 535-538; Hossain *et al.*, 1994, p.341) and thus provide a precedent for the use of an unweighted disclosure index in the present study. Thus, the present researcher has used only an unweighted disclosure index approach in this research. The fundamental theme of the unweighted disclosure index is that all items of information in the index are considered equally important to the average user. The obvious advantage of using an unweighted index is that it permits an analysis independent of the perception of a particular user group (Chow and Wong-Boren 1987, p.537). If various users are asked to assign weights to different items of information, there is a possibility of assigning different weights to the same items of information. Indeed, the choice of an unweighted index over a weighted one may not produce substantially different results (e.g. Chow and Wong-Boren 1987, p.537).

The method of initially computing the disclosure score for each banking company can be expressed as follows:

$$DCOR = \sum_{j=1} \frac{dj}{n}$$

Where DCOR = the aggregate disclosure score; $d_j = 1$ if the j th item is disclosed or 0 if it is not disclosed; and n = the maximum score a banking company can obtain. In this case, the key fact is whether or not a company discloses an item of information in the annual report. Thus, the unweighted disclosure method measures the total disclosure (TD) score of a banking company as additive (suggested by Cooke, 1992).

In addition, to satisfy the econometric assumption that the distribution of the dependent variable should not be constrained to lie between 0 and 1, the DCOR should be transformed logarithmically (using natural logs). Following Ahmed and Nicholls (1994, p.69), the aggregate disclosure score computed for each company would therefore be transformed by applying the following formula:

$$\ln \text{DCOR} = \log \left[\frac{y}{y-1} \right]$$

Where, $\ln \text{DCOR}$ = the logarithmically transformed disclosure score; and Y = the computed disclosure score for each banking company.

5.9 Dependent Variables

The unweighted disclosure index DCOR subject to logarithmic transformation to $\ln \text{DCOR}$ has been used as the basis for the dependent variables used in the empirical analysis reported in the thesis. Four versions of dependent variable are used, three of which represent decompositions of the total value of all disclosure items. Thus, version 1 of DCOR relates to all disclosure items, mandatory and voluntary, aggregated into one index. Versions 2 and 3 of DCOR separate mandatory and voluntary items into separate sub-indices for analysis. Finally, version 4 extracts the disclosure items relating to corporate governance disclosures for a separate analysis.

5.10 Independent Variables

The independent variables used in the various models analysed in this research to explain levels and variations in disclosure by sample banks have been selected after a consideration of previous studies by various researchers (see in particular Cerf, 1961; Singhvi, 1978; Singhvi and Desai, 1971; Buzby, 1974; Stanga, 1976; Belkaoui and Kahl, 1978; Firth, 1979; Marston, 1986; Chow and Wong-Boren, 1987; Wallace, 1987; Cooke, 1989a, 1989b, 1991, 1992, 1993; Malone *et al.*, 1993; Hossain *et al.*, 1994; Ahmed and Nicholls, 1994; Wallace *et al.*, 1994; Hossain *et al.*, 1995; Wallace and Naser, 1995; Raffournier, 1995; Ahmed, 1996; Inchausti, 1997; Marston and Robson, 1997; Patton and Zelenka, 1997; Cooke, 1998; Hossain, 1999, Haniffa and Cooke , 2002; and Baumann and Nier, 2003). The variables that have been considered in the study are as follows:

1. Age of bank (in years)
2. Size of bank (proxied by total assets).
3. Profitability of bank (proxied by Return on Assets [ROA]).
4. Operational history of bank (proxied by a dummy variable for presence or absence of diversification).
5. Degree of geographic diversification of bank (proxied by a dummy variable if the bank has branches sited in at least three areas/states plus any foreign branches; 0 if otherwise).
6. Complexity of business of bank (proxied by actual number of subsidiaries).
7. A market discipline variable (proxied by the ratio of non-performing assets to total assets).

8. A market discipline variable (proxied by the capital adequacy ratio [CAR] for each bank).
9. Multiple listing of bank (measured by actual number of listing with stock exchanges).
10. Assets-in-place of bank (proxied by the ratio of value of net fixed assets to book value of total assets).
11. Level of audit firm monitoring of bank (a dummy variable scoring 1 if the number of auditors is in excess of the statutory minimum number of auditors; 0 if otherwise).
12. Board composition of bank (measured by the ratio of non-executive independent directors to the total number of directors on the board)
13. Dividend policy of bank (proxied by dividend paid).

A detailed discussion of the choice of variables, the associated hypotheses and expected signs is discussed in Chapter Six.

5.11 General Form of Regression Model

The following is the general form of the OLS regression model which has been fitted to the data in order to assess the effect of each variable on the disclosure data associated with the versions of the disclosure index DCOR and to test the associated hypotheses:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} + \beta_{13} X_{13} + e \quad \text{[Equation 1]}$$

Where

Y = Disclosure index

β_0 = the intercept;

X1 = Age of bank (measured in years);

X2 = Size of bank (measured by total assets);

X3 = Bank profitability (proxied for by Return on Assets [ROA]);

X4 = Operational history of bank (proxied for by a dummy variable taking 1 if the bank shows evidence of significant operating history and 0 if otherwise);

X5 = Degree of geographic diversification of bank (proxied for by a dummy variable taking 1 if a bank has branches sited in at least three Indian areas and/or states plus any foreign branches; 0 if otherwise);

X6 = Complexity of business of bank (proxied for by actual number of subsidiaries);

X7 = Market discipline variable (proxied for by the ratio of Non-Performing Assets to total assets ratio);

X8 = A market discipline variable (proxied by the capital adequacy ratio [CAR] for each bank)

X9 = Multiple stock exchange listing (proxied for by the actual number of listing a bank has on with stock exchanges);

X10 = Assets-in-place of bank (proxied for by the ratio of book value of net fixed assets to book value of total assets);

X11 = Level of monitoring by outside auditors (proxied for by a dummy variable taking 1 if the number of auditors monitoring a bank's

financial reports is in excess of the minimum number of auditors; 0 if otherwise);

X12 = Board composition of bank (proxied for by the ratio of non-executive independent directors to the total number of directors on the board);

X13 = Dividend policy (proxied by the dividend pay-out ration, i.e. annual dividends relative to after-tax profits).

5.12 Conclusion

This chapter has described the theoretical framework for which study has undertaken. A number of theories have been in the literature including agency theory, legitimacy theory, stockholder theory, stewardship theory. These theories have been discussed here and found rational to underpinning the thesis. In addition research method and design of the present study has been described. It has explained the rationale for selecting both the mandatory and voluntary items in the disclosure index, the criteria followed in their selection, sample size, and model development. Additionally, it has identified the dependent variables to be taken into account and other matters relevant to the research objectives. A total of 184 items are included in the disclosure index DCOR, comprising 101 mandatory items and 83 voluntary items. These items were selected by reference to regulations form sources directly relevant to Indian banks (for mandatory items) and a variety of academic, regulatory and other sources (for voluntary items). A range of dependent and independent variables have been identified and the general model to be used for empirical testing of the determinants of disclosure set out. In the following chapter I shall discuss the justification for the dependent variables which are included in the model and the hypotheses associated

with each. Following that discussion I shall go on to test the relationships between various corporate attributes and the level of disclosure for the total index, its mandatory and voluntary components, and the elements in the total index referring to corporate governance disclosures.

CHAPTER SIX

DEVELOPMENT OF HYPOTHESES

6.1 Introduction

This chapter deals with the development of hypotheses in relation to the various corporate attributes included in the general form equation 1 in Chapter Five. The selection of corporate attributes, arguments and hypotheses is discussed in line with the existing literature on determinants of corporate disclosure and transparency on the basis of the detailed literature review presented in Chapter Four. I have noted that there are three broad categories of corporate characteristics or attributes that can affect the degree of corporate disclosure and transparency within a market. The first category consists of the financial characteristics of the firm, the second comprises the firm's corporate governance characteristics (Bushman, *et al.*, 2004), and the third consists of market discipline variables (Chipalkatti, 2002, Nier and Baumann, 2003; and Baumann and Nier, 2003). The literature finds that some financial characteristics can influence the degree of corporate disclosure and transparency of a firm as can variables on corporate governance and market discipline characteristics. Therefore, based on empirical evidence, this study has proposed financial variables, corporate governance variables and market discipline variables In the general form equation 1 of Chapter Seven and I now consider the detailed basis of hypotheses associated with that model and its derivatives.

This chapter is structured as follows. Section 6.2 describes various financial characteristics and the development of the study's hypotheses; Section 6.3 highlights

the corporate governance characteristics as corporate attributes; Section 6.4 provides a descriptive analysis of market discipline as corporate attributes; and finally Section 6.5 presents a conclusion.

6.2 Hypotheses Development

Eleven variables, both financial and non-financial, which are intended to capture different firm characteristics that can influence the degree of corporate disclosure, are proposed in this study. These variables are described in detail in the following subsections.

6.2.1 Age of the Bank

The extent of a company's disclosure may be influenced by its age, with age proxying for the bank's stage of development and growth (Owusu-Ansah, 1998). Owusu-Ansah (1998, p.5) pointed out three factors that may contribute to this relationship. First, younger companies may suffer competitive disadvantage if they disclose certain items such as information on research expenditure, capital expenditure, and product development. The competitive disadvantage would arise when the information disclosed by the newly-established companies is used to their detriment by the other competitors. On the other hand, older companies may naturally be motivated to disclose such information as its presentation may be less likely to damage their competitive position. The second potential contributory factor is the cost and the ease of gathering, processing, and disseminating the required information. These costs are likely to be more onerous for younger companies than for their older counterparts. The third and final factor is the situation that younger companies may lack a 'track record' to rely on for public disclosure and therefore

may have less information to disclose or less rich disclosures. Therefore, in principle the age of the bank can be offered as an independent variable in explaining disclosure level.

However, it is important to consider this variable in the context of the Indian banking system rather than simply the general literature on disclosure and also to set this in the context of banking behaviour more generally. As I noted from the discussion of earlier chapters the Indian financial system is characterised by a large network of commercial banks, financial institutions, stock exchanges, and a wide range of financial instruments. From this discussion it is clear that India has long history in the banking sector. Intense rivalry between the various types of banks - private, public, and foreign - exists between them. Consequently, banks may seek to offer attractive service packages to their customers which they hope will increase the level of confidence and keep banks' deposit and profit margins strong. The older banks have demonstrated a willingness to maintain an image of seriousness and dignity (reflecting more general cultural factors) in their reporting and a wish to generate customer goodwill, providing new and attractive services to their customers. In addition displays of corporate social responsibility are common through donations to charity, establishing schools, providing funds to disabled people and so on may positively impact upon a bank's image and reputation. Indeed, commercial banks more generally - faced by the pressures of globalisation, competition from non-banking financial institutions, and volatile market dynamics - are constantly seeking new ways to add value to their services (Soteriou and Stavros, 1997, p.1). Several earlier studies (see Lumpkin and Dess, 1996; and Akhigbe and McNulty, 2003) have produced findings that suggest firm age has an influence on bank performance.

Moreover, Norburn and Birley (1988) and Hitt and Tyler (1991), found that age influences strategic decision-making performance. Performance depends on how the firms achieve their objectives. This may suggest that older banks may disclose more information in their annual reports than newly-established banks, since how banks disclose information and reach their customers is a subjective matter which depends on banks' experiences as well as the attractiveness of their products and services.

Newer banks may be advanced in terms of modern banking facilities such as ATMs, telephone banking, credit and debit cards, on-line banking, and other technology-driven developments. These allow banks to more easily satisfy their customers' demands and to do so promptly, and such services facilitate deposit mobilisation. The annual report is a communication that provides information to users and acts as a bridge to the money or securities markets. A well-developed information market is essential for the proper functioning of a securities market (Mak, 1991, p.311). The banks are playing a vital role in the economy of India. Various users may demand the disclosure of information and their demand may be affected by the potential of the information for reducing uncertainty. Moreover, as with all human activities, financial reporting as well as capital markets, is influenced by culture (Douglas, 1989; and Wildavsky, 1989). Goodenough (1970) observed that the relation of an economic state of affairs to a social one is often largely or entirely, the product of human action that was itself informed and guided by the cultures of the actors. According to Granovetter (1985) the high level of order often found in the 'market' depends on the nature of social relations between individuals and the network of relations between and within firms. For example, distinctive market characteristics found in advanced capitalist countries such as the credit dominated financial system

in Japan, heavy bank ownership of corporate equities in Germany, and priority stock in the Netherlands, reflect the socio-cultural characteristics of those countries (Hussein, 1996, p.97). In India, public sector banks still dominate the country's banking segment (at 92% coverage [Deolalkar, 2000, p. 60]). Indeed, the organisational inertia operating in old firms tends to make them inflexible and unable to appreciate change in the environment. Kakani *et al.* (2001) pointed out that newer and smaller firms, as result, may succeed in spite of disadvantages like lack of capital, brand names and the corporation reputation of older firms. Therefore, it is not possible unambiguously to conclude that longer-established banks will necessarily disclose more information than more newly-established banks. However, on the balance of the theory and evidence I present the following hypothesis (with a weak expectation of a positive statistical relation):

H1: *Longer-established banks will tend to disclose more information than more newly-established banks.*

The length of establishment of banks is measured by age in years.

6.2.2. Size of the Bank

The size of the bank is a potentially important explanatory variable for the extent of disclosure, and most researchers in this area find a close relationship between these two variables, both in developing and developed countries. Studies by Singhvi and Desai (1971), Buzby (1974), Firth (1979), Kahl and Belkaoui (1981), McNally *et al.* (1982), Chow and Wong-Boren (1987), Benjamin *et al.* (1990), Cooke (1989a, 1992), Ahmed and Nicholls (1994), Hossain *et al.* (1994), Wallace *et al.* (1994),

Wallace and Naser (1995), Raffournier (1995), Hossain *et al.*, (1995), and Hossain (1999) have all found a positive relationship between company size and the extent of disclosure. However, four other researchers (Spero, 1979; Stanga, 1976 Wallace, 1987; and Inchausti, 1997) found a negative relationship or no significant statistical relationship in their studies regarding the above association.

A number of reasons have been advanced in the literature in an attempt to justify this relationship on *a priori* grounds. Ahmed and Nicholls (1994, p.65) argued that it is more likely that large firms will have the resources and expertise necessary for the production and publication of more sophisticated financial statements and, therefore, exhibit more disclosure compliance and greater levels of disclosure. Firth (1979, p.274) suggests that

“Collecting and disseminating information is a costly exercise and perhaps it is the larger firms who can best afford such expenses. Furthermore, smaller firms may feel that fuller disclosure of their activities will put them at a competitive disadvantage with other, larger, companies in their industry”.

Singhvi and Desai (1971, p.131) offered three justifications why the extent of financial disclosure is different for firms of different sizes. Firstly, the cost of accumulating certain information is greater for smaller firms than larger firms. Secondly, larger firms have a greater need for disclosure because their securities are typically distributed via a more diverse network of exchanges, and thirdly, management of a smaller corporation is likely to believe more strongly than the

management of a larger corporation that the full disclosure of information could endanger its competitive position. The third point is also supported by Dye (1985), who argues that information may be perceived by managers as proprietary, and that its disclosure may result in the entrance of competitors into the market, thus driving down profits.

Another explanation put forward in the literature for the existence of a positive association between size of the firm and the extent of voluntary disclosure, is the demand for information by financial analysts. For instance, Lang and Lundholm (1993) and McKinnon and Dalimunthe (1993, p.39) pointed out that large firms tend to have more analyst followings than small firms and therefore may be subjected to greater demand for information. Wallace and Naser (1995, p.322) state that “size is a function of growth and the growth of a firm invariably results in a greater need for external capital and consequently a greater need for more comprehensive information”. Cooke (1991, p.176) states that “larger firms are likely to be entities of economic significance so that there may be greater demands on them to provide information for customers, suppliers and analysts, and governments as well as the general public”.

Agency problems may arise between creditors and debtors because of asymmetric information and the (often) fixed value nature of loan contracts: debtors have a concave return function while that of creditors is convex (Ncube and Senbet, 1997). The consequence of these agency conflicts is that banks and other financial institutions could face adverse incentives to undertake investment strategies which might jeopardise their solvency and, therefore the safety of their deposits

(Brownbridge and Kirkpatrick, 1999). Under the above circumstances, *a priori* it is not clear whether this may favour a positive relationship between size and disclosure (explained by economies of scale) or a negative relationship (smaller banks seeking to use increased disclosure to reduce competitive disadvantages due to small size and information asymmetry).

Foster (1986, p.111) suggested three possible proxies for firm size: total assets, net sales³⁰, and capitalised value³¹ of the firm. In addition, some researchers used other proxies in their studies, such as number of shareholders³², capital stock³³, turnover³⁴, current assets³⁵, fixed assets³⁶, shareholders' funds³⁷, bank borrowing³⁸, market value of equity plus the book value of debt³⁹, and net income⁴⁰. Considering the nature of banking companies in India only total assets⁴¹ has been selected as a proxy for size. Thus, the following hypothesis is established.

H2: *The level of disclosure is positively associated with bank size*

³⁰ Also used by Inchausti (1997), Craig and Diga (1998), Raffournier (1995), Ahmed and Nicholls (1994), Wallace *et al.* (1994), Cooke (1989a, 1989b), Wallace (1987), sales turnover by Firth (1979).

³¹ Also used by Benjamin *et al.* (1990), Wallace and Naser (1995), Hossain *et al.* (1994).

³² Cooke (1989a, 1989b, 1991, 1992), Wallace and Naser (1995), Hossain *et al.* (1994).

³³ Cooke (1992).

³⁴ Cooke (1991, 1992, 1998).

³⁵ Cooke (1992).

³⁶ Cooke (1992).

³⁷ Cooke (1992, Benjamin *et al.* (1990), McNally *et al.* (1982), capital employed by Firth (1979, p.278).

³⁸ Cooke (1992, 1998).

³⁹ Chow and Wong-Boren (1987, p.538), market value of equity, Lang and Lundholm (1993, p.258).

⁴⁰ McNally *et al.* (1982).

⁴¹ The following researchers also used this variable as a proxy in their studies, Cerf (1961, p.31-32), Singhvi and Desai (1971, p.131), Buzby (1975, p.24), Belkaoui and Kahl (1978, p.40), Firth (1979, p.279), Kahl and Belkaoui (1981, p.192-195), McNally *et al.* (1982, p.13), Chow and Wong-Boren (1987, p.539), Wallace (1987, p.575), Cooke (1989a, p.118; 1989b, p. 180; 1991, p. 176; 1992, p.231; 1993, p.531), Malone *et al.* (1993, p.253), Ahmed and Nicholls (1995, p.65), Hossain *et al.* (1994, p.342), Hossain *et al.* (1995, p.72-73), Wallace *et al.* (1994, p.44), Wallace and Naser (1995, p.322-323), Raffournier (1995, p.262-263), Ahmed (1996, p.185), Inchausti, (1997, p.53-54), Patton and Zelenka (1997, p.610), and Craig and Diga (1998, p.258), and Hossain (1999, p.103).

6.2.3 Profitability of the Bank

Profitability is undoubtedly a key element in measuring the performance of any business organisation. It can be measured in various ways and techniques for the purpose depend upon the nature of the business. Most researchers have found a positive relationship between profitability and the extent of disclosure (see for example, Cerf, 1961; Singhvi, 1967; Singhvi and Desai, 1971; Belkaoui and Khal, 1981; Wallace, 1987; Wallace *et al.* 1994; Wallace and Naser, 1995; Raffournier, 1995; Inchausti, 1997; and Hossain, 1999).

Banks are engaged in the kind of business where a return is expected. However, the profit earning mechanism depends among other things on how effectively the banks conduct their lending and borrowing activities. The basic philosophy of banks is to collect deposits, sanction advances, and make loans to customers. Within this framework, a bank hopes to build up a profitable investment portfolio to generate a return on its investment. If a bank fails to earn profit, there is a possibility that customer confidence is lost, which ultimately creates a bad impression of the bank or equally seriously, its equity capital is eroded and its ability to make loans reduced. This may create incentives for banks which make losses or whose profits fall to disclose more information by way of explanation in order to maintain confidence. In contrast it may be the case that banking companies with higher or rising profits feel comfortable in disclosing more information than banks with lower profits. Customers, shareholders, financial analysts, and the regulating authority are likely to be more satisfied to receive news of good earnings and bank management may also be pleased to disclose information without hesitation. Thus, banks by the nature of their business, and also being obliged by law, may try both to earn profits and

disclose more information within their own capacities. Thus, although previous research reports a positive association between profitability and disclosure levels there are conflicting arguments in the case of bank. However, taking note of previous research but noting also that much of it was undertaken on non-banking companies, the balance of argument favours banks with higher profit disclosing more financial information than banks with lower profits or losses, and I hypothesis:

H3: *The level of disclosure is positively associated with bank profitability.*

Previous research studies using disclosure indices have been related to non-financial companies and researchers have used such proxies as rate of return on assets (ROA)⁴², rate of return on equity (ROE)⁴³, net profit margin⁴⁴, liquidity⁴⁵, earnings and dividend growth⁴⁶ to measure profitability broadly defined. In considering the nature of the activities of the banking business, return on assets (ROA) has been chosen as an appropriate proxy for measuring profitability of banks in the present study.

6.2.4. Operating History

The studies of Mak (1996, 1989) and Sweeting and Layton (2001) have examined the impact of operating history on the voluntary disclosure of management forecasts. However, in considering the existence of the long history of the Indian banking

⁴² Inchausti, (1997, p.54-55), Wallace and Naser (1995, p.319-320), McNally *et al.* (1982, p.13), Singhvi (1967), Singhvi and Desai (1971, p.131).

⁴³ Patton and Zelenka (1997, p.610), Inchausti, (1997, p.54-55) McNally *et al.* (1982 p.13), Raffournier (1995, p.270)

⁴⁴ Malone *et al.* (1993, p.254), Wallace and Naser (1995, p.319-320), Singhvi (1967), Singhvi and Desai (1971, p.131)

⁴⁵ Wallace and Naser (1995, p.319-320),

⁴⁶ Cerf (1961, p. 32).

sector this variable may bring significant affects to the level of disclosure. In this context, operating history refers to whether the bank has a background in operating a conventional banking business. The discussions of the Indian financial structure, the history of banking in Indian, and relatively recent banking reform give insights into understanding the operating history of Indian banks. As the largest country in South Asia India has a huge financial system characterised by many and varied financial institutions and instruments, and its banking sector was well developed even prior to its political independence in 1947 (Sathye, 2001). At the time of its independence India had only traditional commercial banks, all with private sector ownership. In 1969, the Government arranged the nationalisation of 14 commercial banks, a move followed by six more nationalisations in 1980. The system expanded rapidly after the nationalisation of major commercial banks in late 1969 and “ranks in the top quarter among developing countries” (Khanna, 1995, p.265) and further development both absolute and relative has taken place since. Nationalised banks are generally wholly owned by the government but, some (nine banks, i.e. 33% of the total) have public issues. In addition, Indian banks maintain offices in numerous foreign countries. For example, 95 branches, including off-shore branches and mobile agencies of nine Indian commercial banks (which include eight public sector banks and one Indian private sector bank) were operating in foreign countries as early as March 31st 2000. These branches were spread over 25 countries and located in major international centres like London, Amsterdam, Bahrain, New York, Hong Kong, Tokyo, Frankfurt, and Paris (RBI Bulletin, 2001).

Given the above circumstances, I conclude that many Indian banks have a long history and experience in banking operation in terms of domestic banking and

foreign business despite ownership changes and amalgamations. Therefore, there may be an incentive for bank management to disclose more information in order to maintain corporate performance and goodwill, as well as investor confidence and that this is a function of operating history.⁴⁷ Thus, I hypothesise developed as follows:

H4: Banks with well-established operating histories will tend to disclose more information than those with less established operating histories.

The nature of this variable requires use of a proxy. Given the presence of an age variable operating history cannot be proxied for by age. Similarly (see below) as I include a proxy for geographic and product diversification I seek to distinguish operating history from diversification. Hence, select as a judgemental proxy for operating history expressed as a dummy variable taking the value 1 if the bank exhibits evidence of significant operating history and 0 if otherwise. The values of the dummy have been applied by the researcher after examination of information on the operating history of each bank available from sources other than the annual report which provides data for the disclosure index.

6.2.5 Degree of Geographic Diversification

Diversification has been widely studied in economics, management, and finance, as a means by which a firm expands from its core business into other product and geographic markets (Aaker, 1980; Andrews, 1980; Berry, 1975; Chandler 1962; Gluck, 1985). Research shows that many corporate managements are actively

⁴⁷ In contrast Mak (1999, p.320) found that companies without a long operating history had greater disclosure than others.

engaged in diversifying activities. Rumelt (1986) found that by 1974, only 14% of the Fortune 500 firms operated as single businesses and 86% operated as diversified businesses. Many researchers note a rise in the numbers of diversified firms (Datta *et al.*, 1991; Hoskisson and Hitt, 1990).

The literature on bank structure suggests both efficiency and agency rationales for diversification. In the agency or 'managerial entrenchment' view, managers diversify, especially by acquisition, primarily to increase their compensation, job security, or span of control (Amihud and Lev, 1981; and Born *et al.*, 1988). In the efficiency view, product and market diversification allows banks to reduce firm-specific risk by holding a greater variety of assets and offering a greater variety of services (Saunders *et al.*, 1990). However, risk reduction is not a satisfactory sole rationale for diversification. At least in the case of publicly traded banks, shareholders can always reduce their risk by holding a diversified portfolio of non-diversified banks, gaining the risk-reduction advantages of diversification without incurring the costs of managing a large organisation. For this reason, diversification would be beneficial only if it provides some kind of economies of scope.

There are at least two potential sources of scope economies in financial services: 'internal' or cost economies of scope, in joint production and marketing, and 'external' or revenue economies of scope in consumption. Internal economies of scope may come from excess capacity in computer and telecommunications equipment that can be used for a variety of products, or from customer information (credit histories, ratings, etc.) that can be used jointly to produce multiple outputs (Clark 1988; and Mester, 1987). External economies of scope exist if there are

benefits to the consumer of 'one-stop shopping' for various financial services (Berger *et al.*, 1996).

International diversification involves producing and/or procuring the same products (or services) but developing a wide geographical reach (Kakani *et al.*, 2001, p.8).

Researchers such as Slocum (1997), and Rees (1998), stated that international diversification offers several advantages. Firstly, it allows firms to take advantage of new market possibilities (Wan, 1998); secondly, it also allows firms to exploit their core competencies and distinctive capabilities across units in different international markets (Hoskisson and Hitt, 1990); and finally, firms that are significantly exposed to international markets are able to integrate their operations across national markets, and achieve enhanced benefits of innovation and economies of scale (Caves, 1982).

Banks can reduce their idiosyncratic risk⁴⁸ by merging with other banks. The larger the number of customers served by a bank, the smaller the effect of default by one borrower on the bank's profits. In theory, a bank could reduce its idiosyncratic risk by merging either with a bank located across the street or one located across the nation.

Many researchers have suggested that greater portfolio diversification - with associated improvements in the risk-return frontier facing many banks - might be achieved not through greater scale, but by pooling exposures to a variety of 'environmental portfolios' (defined by Gunther and Robinson (1999) in terms of industries and/or geographic locations). Many papers identify hypothetical or actual cost-, risk-, or profit-efficiency gains through greater geographic or industry

⁴⁸ Idiosyncratic risk is unique to each bank. The factors that influence idiosyncratic risk include the quality of a bank's management and the ability of its borrowers to repay their loans.

diversification (Liang and Rhoades 1988; Boyd *et al.* 1993; Rose 1996; Demsetz and Strahan 1997; Rivard and Thomas 1997; Gunther and Robinson 1999; Hughes *et al.*, 1999; and Allen and Jagtiani, 2000).

Khanna and Palepu (1997; 2000) argue that diversification can be valuable in emerging markets because diversified firms can copy the beneficial functions of various institutions that are present in developed markets. They discuss the imperfections in capital markets, contract enforcement, business-government relations, product markets, and labour markets that make it more difficult for focused firms to survive. Firms can take advantage of these imperfections by diversifying at the firm level, or through membership in industrial groups that are common in many emerging and developed capital markets.

Davis (1982), in discussing where banks would earn future profits, suggested that the international life cycle of banks could be represented by four stages: a foreign department, 'going international', multinational, and global bank. In the first two stages, banks would be servicing domestic customers, while in the latter two, multinationals and others based in overseas markets would be serviced. The contribution of international activities to profitability would be minimal in the first stage, 5-10% in the second stage, and a significant share, say 25-35% of the total, in the third stage. In the fourth stage the distinction between domestic and international would be lost as the focus would shift to customer or product profitability, rather than to domestic and international profitability.

Moreover, in the presence of high stock market volatility, the question of how to reduce risk is foremost in portfolio managers' minds. Since the work of Solnik (1974), it has been known that international diversification is one way to achieve this goal. More recent papers such as those from Heston and Rouwenhorst (1994) and Griffin and Karolyi (1998), provide further evidence on the advantages of cross-country diversification.

A feature of India's banking sector is that the Reserve Bank of India has permitted commercial banks to engage in diverse activities such as securities related transactions (for example, underwriting, dealing and brokerage), foreign exchange transactions and leasing activities. The 1991 reforms lowered the CRR and SLR, enabling banks to diversify their activities. The deregulation and the resulting intensified competition may have left banks with no choice but to engage in risk-taking activities in the fight for their market share or profit margins. As a result, risk-taking would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale, 2000). In addition, diversification promotes efficiency by allowing banks to utilise inside information arising out of long-term lending relationships. Moreover, banks can exploit economies of scope from the production of various financial services since they can spread fixed physical (i.e., branches and distribution channels) and human capital costs (Steinherr and Huveneers, 1990).

Since independence in 1947, the Indian banking has experienced strong growth in terms of branch network, deposits and bank lending. During the colonial and the post-colonial era up to 1969, commercial banks largely confined their activities to

urban, affluent customers and to industry, trade and commerce, in the country's urban areas. After nationalising 14 banks in 1969 and six banks in 1980, the Reserve Bank of India directed these banks to undertake a programme of branch expansion in the rural and semi-urban areas of the country, to reallocate bank credit in favour of priority sectors and adjust interest rates for various types of deposit. As on March 31, 2002, the total numbers of branches of the nationalised banks, the State Bank of India and its associates, and foreign banks, stood at 32,615, 13,453 and 237 respectively (Branch Banking Statistics: Volume-3, March 2002, RBI) compared with the position in 1969, when the numbers of branches of nationalised banks, the State Bank of India and its associates, and foreign banks, were 4,553, 2,462 and 130 respectively.

As noted, nine Indian banks (eight public, and one private sector bank) are operating branches abroad with the number of Indian banks' branches operating abroad standing at 93, while the number of representative offices of Indian banks abroad were 17. The number of wholly-owned subsidiaries of Indian banks abroad and joint ventures abroad were 15 and five respectively (Report of the Performance of the Financial Institution 2002, RBI).

The above discussion implies that banks that have expanded their operations either domestically and/or abroad may disclose more information than those that have not expanded. This leads to the hypothesis that:

H5: *Banks that actively expand their networks either at home and/or abroad will tend to disclose more information than those that have not expanded their networks.*

The variable for degree of geographic diversification of banks is proxied by a dummy variable if the bank has branches sited in at least three areas or states of Indian plus any foreign branches and 0 if otherwise.

6.2.6 Complexity of Business

The study of Haniffa and Cooke (2002) suggested that structural complexity may be significant in explaining variability in the extent of disclosure. Curtis (1978), and Cooke (1989a), argued that structural complexity requires a firm to have an effective management information system for monitoring purposes, and that the availability of such a system helps to reduce the cost of information production per unit, and thus higher disclosure.

In the Indian banking market, there is an evidence of the existence of subsidiaries at home and abroad. For example, the Bank of Baroda, State Bank of India, Bank of India, and Canara Bank all have subsidiaries at home and overseas. Therefore, it is expected that banks with subsidiaries may have effective and efficient management systems, as well as a tradition of regulatory compliance. Thus, it is recognised that such characteristics may increase the level of disclosure. However, this variable did not provide significant results in the study of Haniffa and Cooke (2004), although it was expected to give positive sign. Based on the above arguments, I hypothesise:

H6: *The level of disclosure is positively associated with the complexity of the bank.*

The complexity of business of banks is proxied for by actual number of subsidiaries which a bank has.

6.2.7 Market Discipline

In recent years considerable attention has been paid by researchers and policy makers to the subject of market discipline in banking (Nier and Baumann, 2003 and Ghosh and Das, 2000). The term “market discipline” refers to a market-based incentive scheme in which investors in banking liabilities, such as subordinated debt or uninsured deposits, ‘punish’ banks for greater risk-taking by demanding higher yields on those liabilities (Nier and Baumann, 2003). Market discipline in the banking sector has been described as ‘private counterparty supervision’ (Greenspan, 2001). There are stated to be a number of potential benefits from enhancing market discipline in a country’s banking sector. Firstly, by punishing excessive risk-taking by banks, increased market discipline may reduce moral hazard incentives. Secondly, market discipline may improve the efficiency of banks by pressurising some of the relatively inefficient banks to become more efficient or to exit the industry (Berger, 1991). Thirdly, evidence indicates that markets give signals about the credit standings of financial firms which, when combined with inside information gained by supervisory procedures, can increase the efficacy of the overall supervisory process. Finally, it is argued that market discipline might be able to supplement traditional formal supervisory assessments to distinguish ‘good’ banks from ‘bad’ ones and therefore operate to lower overall social costs of bank supervision

(Flannery, 2001). Even the proposed Capital Accord of the Basel Committee has designated market discipline as one of the three pillars on which future financial regulation systems should be based, arguing that because

“ ... [market] discipline imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner” and expects that the approach “will encourage high disclosure standards and enhance the role of market participants in encouraging banks to hold adequate capital” (Basel, 1999).

Theoretically, the market's disciplining mechanism is supposed to reward banks that provide more transparent disclosures to their investors. For the market's disciplining mechanism to operate, banks must provide full, reliable, and high-quality (i.e., transparent) disclosures of their operations and risks in a timely fashion and must use prudent accounting policies. Better quality public disclosures reduce the level of information asymmetry between bank managers and investors and thereby enhance investor confidence in a bank's stock and in the banking industry. Empirical research has demonstrated that high quality disclosures improve a firm's market liquidity (Welker 1995; Welker 2001) and reduce its cost of capital (Botosan 1997). It is recognised that banks are very highly-regulated institutions and that other stakeholders, as well as the official regulatory bodies, monitor the banking operations closely. Banks have to build up and maintain public confidence in the financial markets through their engagement with various investment projects, by borrowing depositors' funds.

The benefits of market discipline may be particularly important in developing economies because financial systems in these economies tend to be predominantly bank-based. Accordingly, in view of the overwhelming dominance of banks in many developing countries, it is argued that to achieve the benefits which a well-functioning banking system can play in the efficient allocation of savings the enhancement of market discipline may be particularly beneficial (Ghosh and Das, 2000). The importance of market discipline has been recognised by the Reserve Bank of India in its observation that:

“ ... processes of transparency and market disclosure of critical information describing the risk profile, capital structure and capital adequacy are assuming increasing importance in the emerging environment. Besides making banks more accountable and responsive to better-informed investors, these processes enable banks to strike the right balance between risks and rewards and to improve the access to markets.” (RBI, 2001).

Given that India has made significant efforts in recent years to promote the role of market forces in regulating banks, it is to be expected that banks are committed to provide more information in their annual reports. This is reflected in the literature as Cordella and Yeyati (1998) and Boot and Schmeits (2000), pointed to the commitment effect of bank disclosure. According to these authors banks that disclose more information may be choosing a lower level of default risk equilibrium. The argument supporting this proposition is that a bank that discloses its risk-profile

exposes itself to market discipline and will, therefore, be penalised by investors if it has chosen a higher risk. This effect is absent if investors do not know the risk-profile of the bank, and weaker if the amount of information available to investors is limited. As discussed in earlier chapters, India has undergone an extensive programme of liberalisation of the banking sector with the avowed objective of “enhancing efficiency, productivity and profitability” (RBI, 1991). More generally, the Indian banking sector has witnessed an important transformation, driven by the national economic need for “creating a market-driven, productive and competitive economy” in order to “support higher investment levels and accentuate growth” (Government of India, 1998), and pursued through the prescription of prudential norms and reorientation in the regulatory framework in line with international best practice. For example, over the last few years, bank supervisors have undertaken steps towards improving the quality and availability of information on banks. Currently, banks are required to disclose, among others, not only their capital adequacy ratios (tier I and tier II, separately), ratios of net NPA to net advances, and return on assets and government holdings, the amount of subordinated debt raised as tier II capital, movements in NPAs, the maturity pattern of deposits and borrowings, and lending to sensitive sectors. These disclosure requirements have recently been enlarged to encompass disclosures on movements in provisions held towards (a) NPAs and (b) depreciation in investment portfolio, both requirements effective from March 31st 2002.

A commonly adopted method of bank risk assessment by regulators which captures certain characteristics of market discipline and is based on bank-specific variables is

referred to as the CAMEL rating.⁴⁹ CAMEL is an acronym derived from five major parameters of bank operations which form the basis of the rating system and cover (C)capital adequacy, (A)asset quality, (M)management competence, (E)earnings and (L)liquidity. Official CAMEL ratings are not generally published to avoid stimulating bank runs but researchers have undertaken indirect studies to examine the efficacy of CAMEL ratings⁵⁰ and they generally conclude that publicly-available data, combined with regulatory CAMEL ratings, can identify and/or predict problems for failing banks. Studies (see for example Sinkey, 1975; Martin, 1977; and Espahbodi, 1991) conclude that CAMEL ratings generally reflect the soundness of financial institutions. CAMEL ratings are adopted by the Central Bank of India as part of its regulatory processes.

Based upon the above discussion, it might be argued that CAMEL rating would be an appropriate proxy for a market discipline variable to be used as an explanatory variable for bank financial disclosure. However, in the absence of published data of CAMEL ratings for Indian banks, two alternative variables have been chosen to proxy market discipline, namely the ratio of non-performing assets (NPA) to total assets and the capital adequacy ratio (CAR). This choice is justified as follows. Two established measures of the health and robustness of a country's financial system are the extent of non-performing assets in its banking system and the presence of appropriate regulatory oversight. Several countries, both advanced and developing, have experienced such banking crises that have shaken the financial stability of their

⁴⁹ CAMEL was instigated in the US

⁵⁰ The five elements of CAMEL are generally defined as follows: C, capital adequacy, by the ratio of capital to risk-weighted assets (CRAR); A, asset quality, as the ratio of non-performing loans to total loans (GNPA); M, management competence, as the ratio of non-interest expenditures to total assets; E, earnings, as the return on asset ratio; and L, liquidity, as the ratio of cash plus balances with the Central Bank to total assets.

economies. For example, the Savings-and-Loan crisis of the USA in the late 1980s, the banking crises in Thailand and other Asian countries during the Asian crisis, the Latin American debt crisis of the early 1980s, and the more recent Argentine banking and currency collapse, all involved disproportionately large NPAs in the assets of the banking sector in those countries and imply problems of regulation. NPAs can form a substantial burden for individual banks as well as for the entire banking system of a country. Their presence indicates poor quality in the assets of the bank and they have to be provisioned for using a bank's capital. Clearly, provisioning for them together with the implications of non-payment of interest will have a negative impact on a bank's profitability and can lead to the complete erosion of its asset base if not controlled. NPAs are a key issue in banking and indeed financial stability in many countries. Likewise capital adequacy ratios are central to the regulatory systems and their management, monitoring and disclosure are indications of the financial stability of a system.

In India, broadly speaking, a non-performing asset is defined as one with interest or principal repayment instalments unpaid for a period of at least two quarters. The Indian banking sector has had an experience of NPAs associated *inter alia* with decades of government-controlled banking, and politically and socially-motivated lending often marked by cronyism, favouritism, and lack of transparency. This created in a number of banks sizeable portfolios of non-performing assets which required recognition of losses on the assets concerned and re-capitalising banks to withstand the write-downs. These issues were central to the Indian banking sector reform process and policy. As noted in earlier chapters India has a developed

regulatory system whose central bank establishes and monitors capital adequacy ratios.

Despite the general arguments about the relationships between market discipline generally and financial and other disclosures it is not entirely straightforward to argue *a priori* on the likely effects of NPA variability on financial disclosure variability. Disclosures generally may be affected as may disclosures on NPAs and related variables specifically. If banks can maintain rates of NPAs lower than a comparable target rate, or keep them at a minimum, there might be an impact on disclosures on NPAs and related variables specifically. However, if NPAs are greater than a comparable target rate or dangerously high there may be no impact or a negative impact on disclosures on NPAs and related variables specifically because, as the issue of NPAs is sensitive in respect of risk management, banks may wish to try to avoid disclosing adverse information to avoid a bank run or regulatory intervention and if NPAs exceed a certain threshold, they may begin to threaten the viability of the bank in question. In contrast, if NPAs are high a bank may increase more general disclosures to provide reassurance and off-set the negative external impact of a poor NPA position. On balance, I postulate a negative relationship between NPAs and disclosure and hypothesise as follows:

H7: The NPA ratio will be negatively associated with disclosure levels.

Similar arguments apply to the capital adequacy ratio (CAR) and its relationship to disclosure levels and variation and as a consequence I hypothesise:

H8: *The CAR ratio will be negatively associated with disclosure levels.*

6.2.8 Multiple Stock Exchange Listing

Foreign listings are becoming an increasingly important strategic issue for companies and stock exchanges alike. As companies become global in their product market and investment strategies, direct access to foreign capital markets via an equity listing, can yield important benefits. At the same time, the international integration of capital markets has led to unprecedented levels of competition among stock exchanges. In this competition, the winners are the exchanges that manage to attract more foreign listings and the attendant trading volumes and business opportunities (Marco *et al.*, 2001). Moreover, by listing abroad, firms may improve the terms on which they can raise capital or on which their shareholders can sell existing securities. This motive is strongest if the firm or its shareholders need to raise capital and if financial constraints in the home market are significant. Empirical analyses of the phenomenon generate various predictions, some of which are concerned with the reason why capital is needed, and others with why cross-listing makes capital cheaper (Marco *et al.*, 2001). The major benefits of listing on a foreign exchange as noted by Saudagaran (1988), and Biddle and Saudagaran (1991), can be financial, marketing and public relations, political, and employee relations. Since higher expected growth should translate into higher price-earning ratios (P/E), one would also expect them to have higher price earnings ratios than comparable domestic companies.

In designing corporate strategies, firms systematically seek to anticipate and exploit opportunities in their business environment. Listing on a stock market at home and/or abroad in order to credibly commit to a better legal regime, is but one of several different motivations for making a foreign (single) or dual listing, and financial motivations have been cited as being by far the more important reasons among them (Lich, 2001). Motivations in this context revolve around realising international diversification and segmentation gains and increasing the liquidity of a firm's equity⁵¹. As a result, firms can lower the expected return on equity and thus broaden the scope of feasible business projects. Another category of motivations includes other business goals, foremost among which, is the desire to increase the issuer's visibility in the capital and product markets.

In the above discussions, it is recognised that despite the various incentives for a company to seek to list additionally on foreign stock exchanges in so doing, a company listed on several stock exchanges, either at home and/or abroad, will have to comply with the regulations of the particular stock exchanges involved, and thus be required to make more disclosures in total and these may be contained in one document. Some of the same arguments can be applied to multiple listings within an economy if the stock exchanges involved have varying regulatory and disclosure requirements. In the case of India, all the public sector banks have to be listed on three stock exchanges, but this regulation is not applicable to the private sector banks. Analysis of sample banks' annual reports indicates that the number of stock exchanges on which the sample banks are listed ranges from three to seven. Thus, the

⁵¹ See for example Yakov and Mendelson (1988) and Errunza *et al.* (1999)

multiple listing is present amongst Indian banks and I extend the argument to capture all multiple listings, home and abroad and hypothesis:

H9: *There is a positive association between listing with multiple stock exchanges and the extent of disclosure of information.*

6.2.9 Assets-in-place

As is well known, financial reporting is one means of mitigating agency problems (Healy and Palepu 2001; Jensen and Meckling, 1976). For example, Leftwich *et al.* (1981) found that the debt ratios of companies which were semi-annual reporters in the US were significantly higher than the corresponding ratios for the other reporting frequencies; and assets-in-place, used in this context as a proxy for information asymmetry, of semi-annual reporting firms was lower than that for other reporters. Hossain and Mitra (2004) found assets-in-place to systematically influence the level of voluntary disclosure of US multinational companies. Butler *et al.* (2002) argued that firms with a higher percentage of tangible assets have lower agency costs because it is more difficult for managers to misappropriate well-defined assets-in-place than to extract value from uncertain growth opportunities. Therefore, since those firms with higher than average assets-in-place may tend to have lower levels of agency costs, they can reduce their reliance on disclosures in line with lower levels of agency costs. It may also be argued that firms with relatively high levels of debt financing have higher agency costs, and therefore, exhibit a greater demand for monitoring by creditors and others. These relationships may be mitigated where there are relatively higher levels of (or increases in) a firm's fixed assets, thereby resulting in lower in agency costs, and consequently lower disclosure (Myers, 1977). Myers

(1977) assertion that wealth transfers can be more difficult between shareholders and debt-holders for firms with a larger proportion of assets-in-place is the source of this mitigation. However, some studies which have investigated the influence of variables capturing assets-in-place on voluntary disclosure in annual reports do not report any significant relationship (Chow and Wong-Boren 1987, Hossain *et al.*, 1994, Hossain *et al.*, 1995, Raffournier, 1995). Therefore, there is no unambiguous support for a hypothesis associating disclosure levels with assets-in-place and it is difficult to predict the sign of the relationship particularly for banking companies. However, with this in mind and after considering the foregoing discussions the following hypothesis is offered:

H10: *There is an association between the proportion of assets-in-place and the extent of disclosure of information.*

6.2.10 Influence of Audit Firm Monitoring

There are studies which have examined empirically the relationships between the characteristics of the audit firm which monitors the annual reports of firms and levels of firm disclosure. Various formulations of audit firm variables have been used in such studies including audit firm size (Ahmed, 1996; Karim, 1995;), its international links (Hossain, 2001; Hossain, 1999; Ahmed and Nicholls, 1994; Benjamin *et al.*, 1990, Wallace and Naser, 1995; and Patton and Zelenka, 1997), and variables capturing auditor quality⁵² (Krishnan and Schauer, 2000; and Kent and Ung, 2003).

⁵² Auditor quality has been captured by a dichotomous variable which was given the value of one if the disclosing firm appoints a large audit firm (ie Big Four, Five, Six, or Eight depending on the date of the study) and a value of zero otherwise.

Financial reporting is seen as an important process by which companies and other entities communicate their financial performance during and at the end of a particular period (Manson and Zaman, 2001). This reporting is considered to be necessary for the efficient allocation of capital and also to demonstrate the stewardship of the directors to the owners of companies (see Gwilliam, 1987). Since, however, the financial reports are generally prepared by individuals who are implicated in the performance of the entity, there is reason to believe that such individuals may be motivated to present a picture of the entity that is in line with their own objectives, rather than those of the shareholders or other users of the financial reports or stakeholders in the firm. Because of the possibility of mis-statement of the financial reports it is practice to have them mandatorily audited by an independent external auditor or, where mandatory legal audit requirements are not in place, for preparers of financial statements to offer to have them independently externally audited on a voluntary basis.

There are some arguments that the credibility of the firm's financial statements is enhanced when the firm hires a brand name auditor (Titman and Trueman, 1986). The presumption is that the largest international audit firms (formerly the Big Eight and now the Big Four ⁵³) provide more thorough audits because they have fewer incentives to compromise on audit quality (DeAngelo, 1981), and also have the resources to conduct comprehensive audits (O'Keefe *et al.*, 1994). Companies with strong reputations can also benefit and protect their reputations by employing high-reputation auditors (Datar *et al.*, 1991; Menon and Williams 1991, 1994; Teoh and

⁵³ The Big Eight consisted of Arthur Andersen, Arthur Young, Ernst and Whinney, Deloitte, Coopers, Peat Marwick, Price Waterhouse, Touche Ross and now the Big Four since a series of mergers and the collapse of Arthur Andersen .

Wong 1993). Auditee firms can, in effect, rent auditors' reputations (Ribstein 2004). Auditor reputations are important in the audit market because they are a source of competitive advantage (DeAngelo 1981; Fombrun 1996) and should affect the competitive position of audit firms (Mahon, 2002). Thus, because audit firm reputations are valuable assets, audit firms (like their high-reputation clients) will seek to protect their reputations by providing high quality audits by fulfilling their obligations to monitor on behalf of investors and other users of financial statements who rely on audit reports. Moreover, a clean audit opinion from a large auditor can be seen as a signal that the auditee firm's reported earnings are of a superior quality to those of other firms. Because large auditors are perceived to be more vigilant, a low-quality auditee firm might not be able to disguise its reported earnings as high quality when they were lower quality. Thus the argument runs that an auditee would be unable to successfully manipulate their earnings through accounting policy choice decisions and also simultaneously receive a clean audit opinion from a large audit firm.

Against this background of theory, I note that researchers have proxied the relationship of auditor to financial disclosure in three dimensions, i.e. audit firm size, audit firm link with international audit firm, and by variables linked to smaller, non-brand (domestic) audit firms. In the research reported in this thesis the relationship has been adapted to reflect the institutional reality that most audit activity is undertaken by non-Big Four international firms and that domestic audit firms in India can typically be characterised as sole proprietorship firms which are hence small in size (although there exist some partnership audit firms).

Under Indian banking regulations both private sector and foreign banks are required to receive prior approval from RBI before appointing their auditors. The public sector banks appoint their statutory auditors (principal auditors and branch auditors) on the basis of the recommendations of the RBI (except for the State Bank of India where the principal auditors are appointed directly by the RBI as per State Bank of India Act); this recommendation is made from the list of RBI-empanelled auditors. A statutory principal auditor relies on branch auditors' reports for issuing audit opinion on the bank's annual financial statements. The list of RBI-empanelled auditors is compiled from a self-disclosure form completed annually by interested auditors.⁵⁴ Bank statutory auditor appointment, re-appointment, or removal requires RBI approval. All state-owned banks must have a minimum of four (joint) statutory auditors. In contrast, there is no limit for private sector banks. Bank auditors must be replaced at least once in four years. No audit firm is allowed to audit more than four private-sector banks and one state-owned bank during any single year (ROSA, 2004).

Examination of the Indian audit markets reveals that despite the presence of Big Four involvement smaller firms are numerically dominant and are still very active in Indian auditing, even though the Indian affiliates of large international firm networks audit approximately 47% of the top 100 listed companies and have significant market

⁵⁴ The lists include both statutory principal and branch auditors. The empanelled list of branch auditors (about 25,000 eligible audit firms) is submitted by the ICAI to the Reserve Bank. The statutory principal auditor list (482 eligible audit firms with a minimum of seven full-time chartered accountants, of whom five should be full-time partners, effective 2005-06) is obtained from the Comptroller and Audit General of India's empanelment data. In addition, banks also directly appoint concurrent auditors, who conduct internal audit. Statutory principal auditor appointment is based on five criteria: number of partners, number of qualified chartered accountants, previous bank experience, previous experience with state-owned enterprises, and number of years in practice. Total audit units in the banking sector are estimated at over 40,000.

penetration in other sectors.⁵⁵ The ICAI reports that about 53,245 audit firms operate in India, including members or affiliates of most of the international networks of accounting firms. About 1,000 firms audit at least one economically-significant enterprise; and about 15 of the largest firms audit more than 70% of the top 100 listed companies. Government-owned companies, unlisted companies, public sector banks, and insurance companies are generally audited by small- and medium-size firms, apparently due to the un-remunerative fee scales prescribed for these engagements⁵⁶. In most cases, the regulator or the Office of the Comptroller and Auditor General of India mandates joint auditors for state-owned enterprises⁵⁷, public sector banks, and insurance companies. The name of any audit firm that wishes to register for ICAI membership must have a combination of the names of the partners or a name in being, that is a name in use before this rule was introduced⁵⁸.

It is evident from examination of the sample Indian banks' annual reports that the situation regarding the number of auditors is not homogenised. The number of auditors of the public sector banks ranges from five to six, except for the State Bank

⁵⁵ Local affiliates of large international networks audit 11 out of the top 50 Indian companies and jointly audit six other companies in the top 50 with another medium-size firm (for 34% of the top 50). They also audit 25 out of the top 51-100 companies and jointly audit five 5 other companies in that bracket with another medium-size firm (for 60%).

⁵⁶ 35 Recently revised audit fee scales for banks prescribe a progressive fee arrangement. Based on total asset size, the maximum fee is set at US\$13,000 for banks with assets exceeding US\$20 billion, and the minimum fee is set at US\$9,500 for banks with total assets less than US\$2.5 billion.

⁵⁷ The largest state-owned enterprise, Oil and Natural Gas Corporation Limited, had five joint statutory auditors in 2002-03. The largest Indian bank, State Bank of India, had 14 joint statutory auditors in 2002-03.

⁵⁸ Because of this 1988 regulation, two Indian affiliates of the Big Four international network firms operate using their pre-1988 registered brand names. The other two did not have any firms registered with the ICAI pre-1988 and hence, use completely unconnected Indian member firm brand names. Also, all four firms and some other larger international networks have private limited companies registered in India that use the global brand and actively sell all the firms' services, other than those restricted to be provided by ICAI members. These private limited companies are not required to follow the strict code of ethics and are not subject to other ICAI rules and regulations.

of India (which has 14 auditors), whereas the number of auditors in the case of private sector banks is between one and three. Given the issues evident in the theoretical and pre-existing empirical literature it is relevant to hypothesise and investigate an association between audit monitoring and levels of disclosure. The nature of the Indian audit market has led us to select a quantitative proxy for the audit monitoring influence and consequently I hypothesise that:

H11: *There is a positive association between the number of auditors engaged by a bank and the extent of information which is disclosed.*

The audit variable is proxied by a dummy scoring 1 if the number of auditors engaged by a bank is in excess of the statutory minimum number of auditors and 0 if otherwise.

6.2.11 Corporate Governance

The processes and structures of corporate governance have received substantial attention in recent years from policy makers, academics and other commentators. In the past few years, corporate governance has become a popular topic of discussion in Europe and, increasingly also in the South East Asian region. Having been a topic of academic research for a long time in the Anglo-Saxon literature, corporate governance has only recently moved from being a special interest, into all sections of the corporate sector and the political scene. It has been a dominant policy issue in developed market economies for more than a decade, lately particularly in

Continental Europe and Japan. In the transition economies it took some time for corporate governance to enter policy priorities, but since the mid-1990s it has been an important and hotly contested issue. In the wake of the Asian financial crisis of the late 20th Century, corporate governance also became a central issue in discussions about the causes of financial instability and the solutions to it, as well as being discussed as an issue in the development debate.

In India, corporate governance issues came to the fore when three scandals happened between 1990 and 1994 (for details see Goswami, 2001). The first was the Harshad Mehta cartel case in the early 1990s, a major securities scandal involving a large number of banks that resulted in a near stock market crash. The second was a sudden growth in cases of multinational companies consolidating their ownership by issuing preferential equity allocations to their controlling shareholder groups at steep discounts to the current market price of their equity (Goswami, 1996, pp.124-25). The third scandal occurred during 1993-94 and involved company share issues which took advantage of a strongly rising stock market. Between July 1993 and September 1994 the Indian stock index increased by 120% and during this boom hundreds of obscure companies made public issues at large share premiums supported by strong stock market sentiment and buttressed by strong marketing efforts from some hitherto insignificant investment banks and based on what were subsequently considered to be misleading prospectuses. These three episodes led to a vigorous debate about corporate governance in India among the financial press, banks and financial institutions, mutual funds, shareholders, the more enlightened business associations, regulatory agencies, and the Government in India. It should be noted that the corporate governance code proposed by the Confederation of Indian Industry

in the aftermath of these scandals (Bajaj, 1997) was modelled along the lines of the Cadbury Committee (Cadbury, 1992) in the United, further evidencing the cultural influence of Cadbury-style ideas of corporate reform through self-regulation (Parkinson, 1993, p.5).

The foregoing discussion shows that concern with corporate governance follows several themes including the good conduct of the internal business affairs of companies, the efficient and equitable operation of capital markets, and the stability and effectiveness of banking. Thus, in addition to being an important instrument of investor protection, strong corporate governance is indispensable for the vibrant growth of any capital market and economy. This applies strongly to banks and this is important in the context of the present research since banks form a crucial link in a country's financial system and their well-being is imperative for the growth of an economy. Since people deposit their money with banks this presupposes a large amount of trust which also necessitates that corporate governance mechanisms for banks should encapsulate depositors as well as shareholders. The depositors are generally not aware of their bank's loan portfolio because such information is not communicable to them practically and is expensive to reveal to the market. This information asymmetry can give banks the incentive to invest in riskier assets than originally promised to both shareholders and depositors. In such a scenario, if the investors and depositors are naïve and uninformed, the gains from investing in a riskier portfolio accrue to bank owners while the costs through higher than anticipated levels of risk is partly borne by depositors. This problem can be addressed in several ways including through the government providing implicit or explicit deposit insurance. If this route is taken exclusively it might succeed in

encouraging individuals and companies to deposit their funds in banks under conditions of uncertainty about risks but in such circumstances a substantial part of the moral hazard cost would be borne by the deposit insurer (and potentially the taxpayer). An alternative is for the government and other regulatory agencies to impose or in other ways encourage banks to adopt appropriate corporate governance structures and processes to mitigate agency theory problems. Thus, the corporate governance mechanisms of banks are direct and indirect interest to the government and ultimately to the taxpayer.

A range of corporate governance variables have been postulated to have influences on numerous aspects of business activity and performance and have been introduced into empirical studies including those on financial disclosure. Within the growing literature on corporate governance issues, discussions on the function of directors in the disclosure process have begun to be more extensively explored. Grace et al. (1995) tried to relate corporate performance to board composition and non-executive directors' characteristics while Shamsheer and Annuar (1993) examined the conflicts between management's and owners' interests by looking at the influence of variables for board composition and role duality.

Board composition has been defined as "the proportion of outside directors to the total number of directors" (Shamsheer and Annuar, 1993, p.44), thereby making a distinction between executive and non-executive directors. There are two conflicting views on the issue of appropriate board composition for a company, those who argue for more non-executive directors on boards and those who favour more executive directors on boards. Those who are in favour of more non-executive directors on the

board base their arguments on two theories; agency and resource dependency. The relevant premise of agency theory is that boards are needed to monitor and control the actions of directors due to their tendency to engage in opportunistic behaviour (Berle and Means, 1932; Williamson, 1985; and Jensen and Meckling, 1976). Mangel and Singh (1993) believe that outside directors have more opportunity for control since they face a less complex structure of incentives than internal directors who frequently have in addition to their direct responsibilities as directors equity positions. In other words, non-executive directors are seen as the check and balance mechanism in enhancing boards' effectiveness. Others who also see the role of non-executive directors as monitors and controllers of management's performance and actions include Fama and Jensen (1983), Brickley and James (1987), Weisbach (1988), Pearce and Zahra (1992), Byrd and Hickman (1992), Salmon (1993), and Pettigrew and McNulty (1995). Additionally, outside directors may be considered to be decision experts (Fama and Jensen, 1983), may reduce managerial consumption of pre-requisites (Brickley and James, 1987), will not be intimidated by the CEO (Weisbach, 1988), and act as a positive influence over the board of directors' deliberations and decisions (Pearce and Zahra, 1992).

Besides the independence of boards for control, the presence of non-executive directors on boards can provide "additional windows on the world" (Tricker, 1984, p.171). This suggestion is illustrative of the resource dependence theory which proposes that non-executive directors can provide firms with links to the external environment due to their expertise, prestige and contacts. Mace (1971) and Spencer (1983) suggest that non-executive directors often see themselves in an advisory role rather than a decision-making role, but since they are appointed because they are

respected for their wisdom and independence, they will tend to be influential and will be listened to although it may not be their function to actually institute policy. Others who also in favour of non-executive directors' dominance on boards ⁵⁹ based on the resource dependence theory include Kesner and Johnson (1990), Wiersema and Bantel (1992), Shamsheer and Annuar (1993) Goodstein, *et al.*, (1994), and Grace *et al.* (1995).

In terms of corporate disclosure, board composition might be an interesting variable to consider because it will indirectly reflect the role of the non-executive directors on the boards. If they are actually carrying out their monitoring role rather than their 'perceived' monitoring role, then more disclosure may be expected. Similarly, their dominance (in terms of numbers and proportionate membership) may provide them with sufficient power to force management to disclose additional information. Board composition has been used as an explanatory variable in empirical research, hypothesising that, *inter alia*, because it is the board of directors that manages information disclosure in annual reports there may be an association between board characteristics and disclosure (Gibbins *et al.*, 1992; and Haniffa and Cooke, 2000).⁶⁰

In the context of the present study I seek to examine whether the strength of the presence of non-executive directors on boards of directors of Indian banks influence the level of information disclosure. I measure the influence of board composition as

⁵⁹ Dominance of non-executive directors on boards can be exercised through a majority of membership on the main board and also through either a majority of the membership of sub-groups of the main board (e.g. the board audit committee) or exclusivity of membership of the board remuneration committee which controls executive directors' compensation.

⁶⁰ In the popular business press interest has often focused on the roles and responsibilities of boards of directors (e.g. Reingold 1999, Brooker 2002, and Useem, 2002).

the ratio of non-executive directors to the total number of board directors and hypothesise that:

H12: There is a positive association between the proportion of non-executive directors on the board and the extent of disclosure of information.

6.2.12 Dividends

A manager can pay shareholders dividends to alleviate their concern about agency problems (Eastbrook, 1984). It is well known that stock price reaction is positively correlated with dividend changes announced by firms (Aharony and Swary, 1980). The use of dividends as a means of signalling entails the cost of shortfall in resources for internally financed investment (Bhattacharya, 1979), higher tax (John and Williams, 1985), and sub-optimal investment (Miller and Rock, 1985). Nevertheless, there is a positive reaction in stock prices to dividend increase announcements, in spite of the higher cost of dividends. Firms that pay dividends may use their dividends as a means to disclose positive information rather than other methods of corporate disclosure. Indeed, it is suggested that the information provided by dividends may substitute for other forms of corporate disclosure (Archambault and Archambault, 2003), and this is may be especially true in instances where capital markets are less developed and/or are subject to manipulation in the trading of securities (Previts and Bricker, 1994). If dividends are an alternative method of market communication to financial disclosures through company annual reports

firms that pay dividends may reduce their levels of corporate disclosure. Thus the hypothesis is:

H13: *There is a negative association between bank dividend payments and the level of disclosure.*

Dividend policy is proxied by the dividend pay-out ratio (i.e. annual dividends relative to after-tax profits).

6.3 Conclusion

The foregoing discussion has established the basis for developing the hypotheses to be tested in the study. I now move on to test these hypotheses in the context of various modelled applied in two contexts in this study. The first context is to use the associated explanatory variables within model frameworks to assess the determinants of levels and variations in general bank disclosures, presented as an index of total disclosure and then differentiated into mandatory and voluntary elements. The second context is as elements in a model to explain levels and variations in disclosure of corporate governance information only. It is hoped that the results presented in the following chapters will contribute to understanding of the determinants of firm disclosures generally and in addition, because of the industry focus of the research, the results will provide insights into a relatively under-researched business sector in general and in developing countries particularly.

CHAPTER SEVEN

GENERAL BANK DISCLOSURES: LEVELS AND VARIATIONS IN RELATION TO FIRM-SPECIFIC DETERMINANTS

7.1 Introduction

This chapter presents the empirical results of the research in relation to levels of bank general disclosures and firm-specific determinants of variations in disclosure. I also consider levels and variations in relation to two components of the overall general disclosure index by decomposing the index into mandatory and voluntary elements. As indicated earlier, the main purposes of the present study are to seek to assess the standard of financial reporting of Indian banking companies, to establish the extent to which Indian banking companies are complying with the rules and regulations which govern them in relation to disclosure, and also to determine whether any corporate attributes have an influence on the extent of disclosure.

The chapter is organised as follows. Section 7.2 describes and analyses the data on levels of disclosure by the sample banks; Section 7.3 provides descriptive and forensic statistics in relation to the variables used in the models, i.e. the correlation matrix and analysis of multi-collinearity; Section 7.4 presents the results of the modelling of the behaviour of the total disclosure index incorporating both mandatory and voluntary items of information; and Section 7.5 contains a comparative position and differences between Indian Accounting Standard and International Accounting Standard; and Section 7.6 provides a conclusion.

7.2 Results on Levels of Disclosure by Sample Banks

Disclosure indices were prepared for each bank according to the methodology discussed in chapter eight above. Performance by the individual sample banks on the total disclosure index is presented in Table 7.1 whilst Table 7.2 presents a statistical summary of scores on the total disclosure index. From Table 7.2 I may note that for all banks the range of scores is from lowest 89 (48.37% of the 184 items in the index) to highest 135 (73.34%) with a mean score of 110.87 (60.25%). The standard deviation of scores was 9.27. When the banks are divided into public and private sector sub-samples private sector banks on average scored higher with a mean of 110.25 (59.91%) against a mean of 106.23 (57.73%) for public sector banks. The scores for public sector banks exhibited a greater dispersion both in terms of range of disclosure score (135-89 versus 128-100) and standard deviation (10.42 versus 8.33). The same patterns are of course shown in the relative percentage scores. In relation to the performance of individual banks a public sector bank was ranked first by level of disclosure, (Corporation Bank) followed by the Bank of Rajasthan Ltd (a private sector bank). The lowest score was obtained by a public sector bank (Dena Bank).

Table 7.1

Performance on Total Disclosure Index by Sample Banks

Bank	Score of Total Disclosure Index (184 items)	Percentage of Items Disclosed (%)	Rank Amongst All Banks According to Disclosure Index Score
Public Sector Banks			
1. Allahabad Bank	107	58.15	10
2. Andhra Bank	114	61.96	7
3. Bank of Baroda	124	67.39	3
4. Bank of India	121	65.76	4
5. Canara Bank	108	58.70	9
6. Corporation Bank	135	73.34	1
7. Dena Bank	89	48.37	15
8. Indian Overseas Bank	104	56.52	11
9. Oriental Bank of Commerce	118	64.13	5
10. Punjab National Bank	118	64.13	5
11. Syndicate Bank	113	61.41	8
12. Union Bank of India	114	61.96	7
13. Vijaya Bank	104	56.52	11
14. State Bank of India	116	63.04	6
15. State Bank of Bikaner & Jaipur	109	59.24	9
16. State Bank of Indore	100	54.35	14
17. State Bank of Mysore	100	54.35	14
18. State Bank of Travancore	114	61.96	8

Table 7.1
Performance on Total Disclosure Index by Sample Banks (continued)

Private Sector Banks			
19. Bank of Rajasthan Ltd.	128	69.56	2
20. City Union Bank Ltd.	107	58.15	9
21. Dhanalakshmi Bank Ltd.	106	57.60	10
22. Federal Bank Ltd.	104	56.52	11
23. ING Vysya Bank Ltd.	121	65.76	4
24 Jammu & Kashmir Bank	108	58.69	9
25. Karnataka Bank Ltd.	104	56.52	12
26. Karur Vysya Bank Ltd.13	106	57.60	10
27. Lakshmi Vilas Bank Ltd.	102	55.43	13
28. South Indian Bank Ltd.	118	64.10	5
29. United Western Bank Ltd.	100	54.35	14
30. Bank of Punjab Ltd.	101	54.89	13
31. Centurion Bank Ltd.	100	54.35	14
32. Global Trust Bank Ltd.	121	65.76	4
33. HDFC Bank Ltd.	107	58.15	10
34. ICICI Bank Ltd.	120	65.21	4
35. IDBI Bank Ltd.	108	58.69	9
36. IndusInd Bank Ltd.	118	64.13	6
37. Kotak Mahindra Bank	109	59.23	9
38. UTI Bank Ltd.	117	63.48	6

Table 7.2**Statistical Summary of Scores on Total Disclosure Index**

	All Banks	Public Sector Banks	Private sector Banks
Mean absolute score	110.87	106.23	110.25
Maximum absolute score	135	135	128
Minimum absolute score	89	89	100
Standard deviation of absolute score	9.27	10.42	8.33
Mean percentage score	60.25	57.73	59.91
Maximum percentage score	73.34	73.34	69.56
Minimum percentage score	48.37	48.37	54.35
Standard deviation of percentage score	5.06	5.66	4.52

Now I consider the disaggregation of the total index into mandatory and voluntary items. Performance by the individual sample banks on the mandatory component of the total disclosure index is presented in Table 9.3 whilst Table 9.4 presents a statistical summary of scores on the mandatory items. From Table 9.4 I observe that for all banks the range of scores is from lowest 75 (74.25% of the 101 items in the index) to highest 99 (98.02%) with a mean score of 89.44 (60.25%). The standard deviation of scores was 5.43. When the banks are divided into public and private sector sub-samples private sector banks on average scored higher with a mean of 91.04 (90.49%) against a mean of 87.28 (86.41%) for public sector banks. The scores for public sector banks exhibited a greater dispersion both in terms of range of disclosure score (99-75 versus 99-86) and standard deviation (6.43 versus 3.22). The same patterns are of course shown in the relative percentage statistics. When the performance of individual banks is considered a public sector bank and a private bank were ranked first equal by level of disclosure, (Corporation Bank and Global

Trust Bank Ltd. respectively). The lowest score was again obtained by the same public sector bank (Dena Bank).

Thus far results are in line with our expectation that mandatory levels of disclosure will be high but the levels of mean score for the mandatory items are all well below 100% which is the logical expectation for mandatory disclosures (at 88.45% for all banks) with public sector banks performing worse than private banks (86.41% relative to 90.49%) suggesting poor levels of compliance and monitoring especially in the public sector institutions. If I turn to the performance of the sample banks on voluntary disclosures I may consider the relative performances of the two sub-samples and gain further insights into disclosure performance.

Performance by the individual sample banks on the voluntary components of the total disclosure index is presented in Table 7.5 and Table 7.6 with the latter presenting the statistical summary of the scores on the mandatory items in both absolute terms and as percentages. From Table 7.6 I may note that for all banks the range of scores is from lowest 11 (13.25% of the 83 items in the index) to highest 36 (43.37%) with a mean score of 21.42 (25.84%). The standard deviation of scores was 7.83. When the banks are divided into public and private sector sub-samples private sector banks on average scored lower with a mean of 18.85 (22.75%) against a mean of 24.28 (29.28%) for public sector banks, thus reversing the relative positions for mandatory disclosures. The scores for public sector banks exhibited the same degree of dispersion in terms of range of disclosure score (36-14 versus 33-11) but showed a lower standard deviation (5.56 versus 6.21). The same patterns are evident in the relative percentage statistics. When the performance of individual banks is

considered the same two public sector banks (Corporation Bank and Dena Bank) were the outliers in that sub-sample, with Corporation Bank being the best voluntary discloser overall. Amongst the private banks three banks shared the lowest voluntary disclosure performance (Karnataka Bank Ltd, United Western Bank Ltd., and Centurion Bank Ltd.).

The results for the analysis of voluntary disclosure are mixed in relation to expectations. Private banks on average disclose less of the voluntary items in the index than do public sector banks and the sub-sample of private banks displays greater dispersion when measured by the standard deviation of the scores. As expected, mean levels of voluntary disclosure are significantly below those of mandatory disclosure for all banks together (illustrated here as percentage scores of 25.84% versus 88.54%) and for both the public sector sub-sample (29.28% versus 86.41%) and the private sector sub-sample (22.75% versus 90.49%) and show significantly more dispersion (illustrated here as standard deviations of percentage scores) for all banks (7.80 versus 5.43) and both public sector banks (6.66 versus 6.37) and private banks (7.59 versus 3.41).

Table 7.3
Performance on Mandatory Elements of Total Disclosure Index by Sample Banks

Bank	Score of Mandatory Items in Total Disclosure Index (101 items)	Percentage of Mandatory Items Disclosed
Public Sector Banks		
1. Allahabad Bank	85	84.16
2. Andhra Bank	87	86.14
3. Bank of Baroda	98	97.03
4. Bank of India	95	94.06
5. Canara Bank	81	80.21
6. Corporation Bank	99	98.02
7. Dena Bank	75	74.25
8. Indian Overseas Bank	84	83.17
9. Oriental Bank of Commerce	84	83.17
10. Punjab National Bank	92	91.09
11. Syndicate Bank	89	88.11
12. Union Bank of India	85	84.16
13. Vijaya Bank	82	81.19
14. State Bank of India	90	89.11
15. State Bank of Bikaner & Jaipur	87	86.14
16. State Bank of Indore	84	83.17
17. State Bank of Mysore	80	79.20
18. State Bank of Travancore	94	93.07

Table 7.3
Performance on Mandatory Elements of Total Disclosure Index by Sample Banks (continued)

Private Sector Banks		
19. Bank of Rajasthan Ltd.	95	94.05
20. City Union Bank Ltd.	89	88.11
21. Dhanalakshmi Bank Ltd.	87	86.13
22. Federal Bank Ltd.	86	85.14
23. ING Vysya Bank Ltd.	92	91.09
24 Jammu & Kashmir Bank	90	89.11
25. Karnataka Bank Ltd.	93	92.07
26. Karur Vysya Bank Ltd.13	90	89.11
27. Lakshmi Vilas Bank Ltd.	90	89.11
28. South Indian Bank Ltd.	94	93.07
29. United Western Bank Ltd.	89	88.11
30. Bank of Punjab Ltd.	89	88.11
31. Centurion Bank Ltd.	89	88.11
32. Global Trust Bank Ltd.	99	98.02
33. HDFC Bank Ltd.	92	91.09
34. ICICI Bank Ltd.	93	92.07
35. IDBI Bank Ltd.	87	86.13
36. Indusland Bank Ltd.	97	96.03
37. Kotak Mahindra Bank	92	91.09
38. UTI Bank Ltd.	95	94.05

Table 7.4
Summary Statistical Scores on Mandatory Elements in Total Disclosure Index

	All Banks	Public Sector Banks	Private Sector Banks
Mean absolute score	89.44	87.28	91.40
Maximum absolute score	99	99	99
Minimum absolute score	75	75	86
Standard deviation of absolute	5.43	6.43	3.22
Mean percentage score	88.45	86.41	90.49
Maximum percentage score	98	98.02	98.02
Minimum percentage score	74	74.25	85.14
Standard deviation of percentage score	5.43	6.37	3.41

Table 7.5
Performance on Voluntary Elements of Total Disclosure Index by Sample Public Sector Banks

Public Sector Bank	Score of Voluntary Items in Total Disclosure Index (83 items)	Percentage of Voluntary Items Disclosed
1. Allahabad Bank	22	26.51
2. Andhra Bank	27	32.53
3. Bank of Baroda	26	31.33
4. Bank of India	26	31.33
5. Canara Bank	27	32.53
6. Corporation Bank	36	43.37
7. Dena Bank	14	16.87
8. Indian Overseas Bank	20	24.10
9. Oriental Bank of Commerce	34	40.96
10. Punjab National Bank	26	31.33
11. Syndicate Bank	24	28.91
12. Union Bank of India	29	34.94
13. Vijaya Bank	22	26.51
14. State Bank of India	26	31.33
15. State Bank of Bikaner Jaipur	22	26.51
16. State Bank of Indore	16	19.27
17. State Bank of Mysore	20	24.10
18. State Bank of Travancore	20	24.10

Table 7.5**Performance on Voluntary Elements of Total Disclosure Index by Sample
Private Sector Banks (continued)**

Private Sector Banks		
19. Bank of Rajasthan Ltd.	33	39.75
20. City Union Bank Ltd.	18	21.68
21. Dhanalakshmi Bank Ltd.	19	22.89
22. Federal Bank Ltd.	18	21.68
23. ING Vysya Bank Ltd.	29	34.94
24 Jammu & Kashmir Bank	18	21.68
25. Karnataka Bank Ltd.	11	13.25
26. Karur Vysya Bank Ltd.	16	19.27
27. Lakshmi Vilas Bank Ltd.	12	14.57
28. South Indian Bank Ltd.	24	28.91
29. United Western Bank Ltd.	11	13.25
30. Bank of Punjab Ltd.	12	14.45
31. Centurion Bank Ltd.	11	13.25
32. Global Trust Bank Ltd.	22	26.50
33. HDFC Bank Ltd.	15	18.07
34. ICICI Bank Ltd.	27	32.53
35. IDBI Bank Ltd.	21	25.30
36. Indusland Bank Ltd.	21	25.30
37. Kotak Mahindra Bank	17	20.48
38. UTI Bank Ltd.	22	26.50

Table 7.6
Summary Statistical Scores on Voluntary Elements of Total Disclosure Index

	All Banks	Public Sector Banks	Private Sector Banks
Mean absolute score	21.42	24.28	18.85
Maximum absolute score	36	36	33
Minimum absolute score	11	14	11
Standard deviation of absolute score	6.45	5.56	6.21
Mean percentage score	25.84	29.28	22.75
Maximum percentage score	43.37	43.37	39.75
Minimum percentage score	13.25	16.87	13.25
Standard deviation of percentage score	7.80	6.66	7.59

I may conclude this section and this stage in the analysis by noting that significant differences appear to exist between mandatory and voluntary disclosure practices and also between the behaviour of public sector and private sector banks. Moreover, there appear to be issues of regulatory compliance for all banks in the sample in relation to mandatory disclosures and also for voluntary disclosure behaviour differences in the strengths of motivations to disclose. I now turn to a consideration of the determinants of disclosure levels and variations in disclosure by the sample banks by first presenting an analysis of the variables used in our models.

7.3 Analysis of Independent Variables

Table 7.7 presents means and standard deviations for the variables used in our analysis.

Table 7.7

Means and Standard Deviations of Variables

	Mean	Standard. Deviation	N
TOTAL DISCLOSURE INDEX	60.2105	5.0626	38
SIZE (LOGASSET)	9.4521	1.5412	38
AGE (AGE IN YEARS)	58.211	36.048	38
OPERATING HISTORY (HISTORY)	0.7105	0.4596	38
DEGREE OF GEOGRAPHIC DIVERSIFICATION (DIVERSIF)	0.6053	0.4954	38
PROFITABILITY (ROA)	1.01500E-02	9.36283E-03	38
MARKET DISCIPLINE (NPA)	5.11816E-02	3.61435E-02	38
LISTING ON MULTIPLE EXCHANGES (EXCH)	3.4474	1.2670	38
CAPPITAL ADEQUACY RATIO (CAR)	3.4589	1.4899	38
COMPOSITION OF BOARD OF DIRECTORS (BOD)	0.6074	.1888	38
DIVIDEND POLICY (DIVIDEND)	0.2988	0.2228	38
SUBSIDIA	3.0526	4.9645	38
AUDIT FIRM MONITORING (AUDIT)	0.3684	0.4889	38
ASSETS IN PLACE (AINPLACE)	0.346790	0.444082	38

Two key issues in model specification concern the presence of correlation and multi-collinearity between the variables. Multi-collinearity in explanatory variables has been diagnosed through analyses of correlation factors and Variable Inflation Factors (VIF), consistent with Weisberg (1985, pp. 196-200). Table 7.8 shows the correlation matrix of the dependent and continuous variables, and Table 7.10 presents other statistics on the independent variables including VIFs. From Table 7.8 it can be observed that the highest simple correlations found between independent variables were at 0.80 between NPA and Age as well as NPA and ROA. Farrar and Glauber

(1967), Judge *et al.* (1985), and Bryman and Cramer (1997), suggest that a simple correlation between independent variables should not be considered harmful until they exceed 0.80 or 0.90. Simple correlations of 0.80 or 0.90 are usually associated with Variable Inflation Factors (VIF)⁶¹ of between 6 and 10. VIFs in excess of 10 should be considered an indication of harmful multi-collinearity (Neter *et al.*, 1989). In the present model, as shown in Table 9.10 the largest VIF was observed for NPA at 6.877. The condition indices remained relatively low, staying below 10, and the highest variance contribution associated with the highest condition index was 0.78 (audit firm variable). The remaining variance contributions were less than 0.60. Therefore, the observed correlations were not considered harmful. These findings suggest that multi-collinearity between the independent variables is unlikely to pose a serious problem in the interpretation of the results of the multivariate analysis.

⁶¹ VIF measures the variance of an estimator compared to what the variance would have been if the independent variable was not collinear with any of the other explanatory variables (Aczel, 1993).

Table 7.8 Correlations Between Independent Variables

LOGASSE	LOGASSE	AGE	HISTORY	DIVE	ROA	NPA	EXCH	CAR	BOD	DIVIDEND	SUBSIDIA	AUDIT	AINPLACE
LOGASSE	1.000	.256	.195	.301	.256	-.210	.001	.554**	-.343*	.320	.140	-.540**	.198
AGE	.256	1.000	-.192	.232	1.000(**)	-.800**	-.357*	.238	.031	.368(*)	.226	-.340*	.170
HISTORY	.195	-.192	1.000	-.159	-.192	.153	-.096	.254	.000	-.142	-.052	-.114	.091
DIVERSIF	.301	.232	-.159	1.000	.232	-.284	.031	.126	-.257	-.116	.448**	-.053	.167
ROA	.256	1.000**	-.192	.232	1.000	-.800**	-.357*	.238	.031	.368*	.226	-.340*	.170
NPA	-.210	-.800**	.153	-.284	-.800**	1.000	.299	-.252	.277	-.341*	-.376*	.200	-.347*
EXCH	.001	-.35*	-.096	.031	-.357*	.299	1.000	-.223	-.127	.259	.460**	.163	-.085
CAR	.554**	.238	.254	.126	.238	-.252	-.223	1.000	-.262	.152	-.031	-.342*	.289
BOD	-.343*	.031	.000	-.257	.031	.277	-.127	-.262	1.000	-.029	-.293	.298	-.398*
DIVIDEND	.320*	.368*	-.142	-.116	.368*	-.341*	.259	.152	-.029	1.000	.274	-.332*	.093
SUBSIDIA	.140	.226	-.052	.448	.226	-.376*	.460**	-.031	-.293*	.274*	1.000	-.164	.412**
AUDIT	-.540**	-.340*	-.114	-.053	-.340*	.200	.163	-.342*	.298	-.332*	-.164	1.000	-.266
AINPLACE	.198	.170	.091	.167	.170	-.347*	-.085	.289	-.398*	.093	.412(*)	-.266	1.000

*Correlation is significant at the 0.05 level (2-tailed)

** Correlation is significant at the 0.01 level (2-tailed)

7.4 Testing the Determinants of the Disclosure Index

Based on the specification of variables in Chapter 6 OLS regression models were fitted to data for the sample banks in order to assess the effect of each independent variable on the total disclosure index, and in turn its mandatory and voluntary components. The general form of the model was as follows:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 \\ + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} + \beta_{13} X_{13} + e \quad [\text{Equation 7.1}]$$

Where Y = disclosure index score;

β_0 = Intercept term;

X_1 = Age of the bank in years (proxy for age);

X_2 = Size of bank (proxied by log of total assets);

X_3 = Profitability of bank (proxied by ROA)

X_4 = Operational history of bank (proxied by a dummy variable for presence or absence of diversification).

X_5 = Degree of geographic diversification of bank (proxied by a dummy variable if the bank has branches sited in at least three areas/states plus any foreign branches; 0 if otherwise).

X_6 = Complexity of business of bank (proxied by actual number of subsidiaries).

X_7 = A market discipline variable (proxied by the ratio NPA of non-performing assets to total assets).

X_8 = A market discipline variable (proxied by the capital adequacy ratio [CAR]).

X_9 = Multiple listing of bank (measured by actual number of listing with stock exchanges).

X10 = Assets-in-place (proxied by the ratio of net fixed assets to book value of total assets);

X11 = Level of audit firm monitoring of bank (a dummy variable scoring 1 if the number of auditors is in excess of the statutory minimum number of auditors; 0 if otherwise).

X12 = Board composition of bank (measured by the ratio of non-executive independent directors to the total number of directors on the board).

X13 = Dividend policy of bank (proxied by dividend paid).

I now present the results of the tests of the above general model on the total disclosure index and in turn its mandatory and voluntary components.

7.4.1 Determinants of the Total Disclosure Index

The model described in Equation 7.1 was first applied with Y as the total disclosure index score for all banks. The overall performance of this model (Model 1) is reported in Table 7.9. with Table 7.10 showing the coefficient values and associated statistics for model 1. Table 7.10 reports that overall the multiple regression model is significant (at $P < 0.005$) with an adjusted coefficient of determination (R squared) which indicates that 47% of the variation in the dependent variable is explained by variations in the independent variables. The coefficients representing bank size (measured by log of assets), and the two market discipline variables (NPA and CAR) are statically significant at the 2% level, while the coefficients for profitability (ROA) was significant at the 1% level, with geographic diversification, stock exchange listing, board membership, complexity of business of bank (proxied by actual number of subsidiaries), and assets-in place were all also statistically significant at levels up to the 10% level. The coefficients for the

variables representing audit firm monitoring, age of bank, operational history and dividend policy were not significant.

Table 7.9
Overall Performance for Model 1

R	R Square	Adjusted R Square	Standard. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.812	0.660	0.476	3.6647	0.660	3.585

Notes:
 1 Predictors for the R statistics are : (Constant), AINPLACE, EXCH, HISTORY, DIVERSIF, AUDIT, CAR, BOD, NPA, DIVIDEND, LOGASSE, AGE, SUBSIDIA, ROA
 2 Dependent Variable: Total Disclosure Index DINDEX

The adjusted R square of 0.476 compares favourably with similar studies using disclosure indices. For example the study of Haniffa and Cooke (2002) reported at 46.3% and Ahmed (1996) at 33.2%.

Table 7.10
Coefficient Values and Associate Statistics for Model 1

Variable	Unstandardised Coefficients		Standardised Coefficients	T Statistics	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	41.693	6.410		6.505	0.000		
LOGASSE	2.089	.618	.636	3.378	.002	.400	2.503
AGE	2.016E-02	.028	.144	.710	.485	.347	2.886
HISTORY	.295	1.571	.027	.188	.853	.696	1.437
DIVERSIF	3.192	1.715	.312	1.861	.075	.503	1.989
ROA	-453.729	149.205	-.839	-3.041	.006	.186	5.376
NPA	-143.305	43.712	-1.023	-3.278	.003	.145	6.877
EXCH	1.676	.900	.419	1.862	.075	.279	3.581
CAR	-1.850	.538	-.545	-3.443	.002	.566	1.767
BOD	11.866	4.899	.443	2.422	.023	.424	2.356
DIVIDEND	3.501	4.087	.154	.857	.400	.438	2.285
SUBSIDIA	-.483	.231	-.474	-2.088	.048	.275	3.633
AUDIT	5.387E-02	1.953	.005	.028	.978	.398	2.512
AINPLACE	3.521	1.887	0.309	1.866	.074	.517	1.934

Note: Dependent Variable: Total Score on Disclosure Index, DINDEX

A detailed discussion is now presented of the hypotheses.

H1: Age: The coefficient on this variable was not significant although the sign is positive as predicted. This implies that the hypothesis that the level of total disclosure is positively affected by the age of the bank cannot be accepted. The hypothesis was formulated on three arguments: younger companies may suffer competitive disadvantage if they disclose certain items relative to older companies may naturally be motivated to disclose such information as its presentation may be less likely to damage their competitive position; cost and ease of gathering, processing, and disseminating information are easier to absorb for more established companies; and younger banks may substitute additional disclosures

for lack of 'track record'. I may conclude that these forces are not sufficiently present or strong in the Indian banking market. An alternative explanation may be that the potentially strong regulatory environment and regulatory authorities which I described in earlier chapters may mean that the banking sector is closely monitored and has been so for some years and since 1990 it has undergone reform, with steps being taken to maintain a high standard of disclosure and transparency. As a result, all banks could be argued to be subject to an established regulatory regime in a mature market with a strong system of rules, recommendation, and guidelines with close monitoring by the regulatory authorities, regardless of their length of time in operation. However, the evidence showing some lack of disclosure of mandatory items casts doubt on this argument. The hypothesis is not accepted.

H2: Size: The empirical evidence derived from the regression model indicates that size by assets is statistically related to the level of information disclosed by the sample of banks in their annual reports. It is significant at the 2% level. The variable asset size (measured by log of assets) was significantly positive and in line with the results from the large body of previous research using this variable (i.e Cerf, 1961, p.31; Singhvi and Desai, 1971, p.137; Firth, 1979, p.279; McNally *et al.*, 1982, pp.16-17; Chow and Wong-Boren, 1987, p 539; Benjamin *et al.*, 1990, p.111; Cooke 1989a, p.120, 1992, p.236; Ahmed and Nicholls, 1994, p. 71; Hossain *et al.*, 1994, p.344; Wallace *et al.*, 1994, p.50; Wallace and Naser, 1995, p.343; Raffournier, 1995, p.273; Hossain *et al.*, 1995, p.80; Hossain, 1999). The positive sign on the coefficient suggests that size has a direct influence on level of disclosure in the banking sector in India. In other words, banks with greater total assets tend to disclose more information than do banks with fewer total assets. The hypothesis is accepted.

H3: Profitability: The sign of the regression coefficient negative and thus was not as predicted and was significant at the 1% level. This was not consistent with the view that more profitable banking companies disclose significantly more financial information than do less profitable ones. The result is thus inconsistent with other previous studies such as Cerf, 1961; Singhvi and Desai, 1971; and Abu-Naser and Rutherford, 1994. The hypothesis is not accepted. However, in our discussion in formulating the hypothesis I noted one argument which pointed to a contrary hypothesis namely that if banks fail to earn profit customer confidence may be lost, which ultimately might erode equity capital and its ability to make loans which may create incentives for banks which make losses or whose profits fall to disclose more information by way of explanation in order to maintain confidence. I also noted that previous research was undertaken on non-banking companies and came down with a balance of argument which favoured banks with higher profit disclosing more financial information than banks with lower profits or losses. The result may also reflect Indian conditions and incentives. The result presented here suggests further research is needed to identify the incentives linking banking profitability and disclose.

H4: Degree of Geographic Diversification: This variable is statistically significant at the 7% level and the sign is also positive as expected. It is, therefore, concluded that if banks are involved in expanding their business either at home and/or abroad, there is an incentive to disclose more information in order to highlight these activities to their stakeholders and thereby create public and investors' confidence, as well as to maintain the organisation's goodwill level. The hypothesis is accepted.

H5: Operating of History: This variable is not statistically significant. The hypothesis was based on the arguments supported by the studies of Mak (1996, and 1989) and

Sweeting and Layton (2001) who examined the impact of operating history on the voluntary disclosure of management forecasts. However, I noted the long history of the Indian banking sector which rather than supporting the hypothesis may dampen the effect of this variable. Additionally, the use of a proxy and choice of the form of proxy may not have captured the underlying influence of the relationship sufficiently strongly. In particular the qualitative judgements required to operationalise the judgemental proxy as a dummy variable may have weakened its effect. Furthermore, rather than reflecting the experiences of banking operations the variable may be captured by the management attitudes and environments of financial reporting. The hypothesis is not accepted.

H6: Complexity of Business: This is significant at 4%, providing evidence that if the bank has a subsidiary at home and/or abroad, it is likely that bank will disclose more information than a bank with no such subsidiaries. Curtis (1978), and Cooke (1989a), argued that structural complexity requires a firm to have an effective management information system for monitoring purposes, and that the availability of such a system helps to reduce the cost of information production per unit, and thus higher disclosure. Haniffa and Cooke (2002) suggested that structural complexity may be significant in explaining variability in the extent of disclosure but their results did not confirm this. Consequently, this is an interesting result and may be reflective of the stage of development of Indian banking as it goes through a period of significant growth, including overseas expansion. The hypothesis is accepted.

H7 and H8: Market Discipline, NPA and CAR: These two variables have been taken as proxies for market discipline. The results show that they are both significant at the 3% and 2% levels respectively, but the signs are negative. The discussion in formulating

these hypotheses was relatively inconclusive and the argument fell on the side of a positive relation therefore as strictly formulated the hypothesis is not accepted.

However, I may be observing in the results levels of disclosure influenced by other management motives than I stressed namely more conservative views of disclosing risk-related information. For instance, in order to maintain standard NPA and CAR ratios as set by RBI guidelines, the bank may pursue low return investments in the hope that a reduction in risk may compensate for the lowering of returns. In this case banks may limit the voluntary disclosure of information regarding future strategies, policies, profit margin and credit risk policy to shareholders, investors and depositors. Secondly, the presence of a substantial number (47%) of public sector banks in the sample and the resulting presence of government shareholders may be another reason. The reality may be that the government as a shareholder does not clearly articulate its expectations regarding risk disclosures at the time the institution is formed. The problem may be further complicated by the fact that governments change and, therefore there is a real risk of changes in expectations. If the expectations of the government shareholder are such that it impairs the economic viability of the entity itself and the government hesitates from providing the required resources in times of difficulty, it could have grave consequences for the future of the entity. As a consequence, it may be that there is a negative relationship between the degree of state ownership of banks and financial development (Barth *et al.*, 2000). Barth *et al.* (2000) have also concluded that on average, the greater the share of bank assets controlled by state-owned banks, the less will be their financial development including the development of disclosure policies. The above implies that government-owned banks may be complying with the rules rather ignoring the consequences of economic actions. Thus, the better the compliance to the rules, the lesser the incentives may be for disclosing information. Finally, the central motivation of market discipline is that bank

owners and managers act conservatively to limit bank risk. If risk increases and depositors demand higher interest rates or withdraw, then discipline has been effective if banks react to it by reducing bank risk. However, since deposits are the major source of funds for banks, depositors' actions may lead the banks to align their risk-taking incentives with those of depositors. In this way market discipline can be a key complement for the discipline imposed by supervisors. Because of supervisory actions, and depositors' reaction, banks usually keep to capital adequacy and risk ratings in favourable positions. This may imply a lower degree of level of disclosure, especially voluntary disclosure.

H9: Multiple Listing: This variable is significant at the 7% and is positive as predicted indicating that the level of disclosure depends on the status of the stock exchange listing. This result is consistent with those of earlier studies including, *inter alia* Hossain *et al* (1994) and Hossain *et al* (1995). The hypothesis is accepted.

H10: Assets-in-place: This variable is significant at 7% and the sign is positive although no sign was predicted. In formulating the hypothesis I noted that studies which have investigated the influence of variables capturing assets-in-place on voluntary disclosure in annual reports do not report any significant relationship (Chow and Wong-Boren 1987, Hossain *et al.*, 1994, Hossain *et al.*, 1995, Raffournier, 1995). Therefore, there was no unambiguous support for a hypothesis associating disclosure levels with assets-in-place. This is a potentially a complex variable to consider for banking companies and also the agency problems associated with the variable may be complicated by the presence of public sector banks in the sample. However, its significance at an acceptable level makes it worth investigating in further research and the sign requires further understanding of the underlying economic relationships. The hypothesis is accepted.

H11: Level of Monitoring by Audit Firms: This variable performed very poorly and was not significant. As noted above the previous empirical literature is mixed on the role of auditor variables in determining disclosure despite the theoretical literature cited. Thus, Craswell and Taylor (1992) found a positive relationship between auditor and voluntary reserve disclosure in the Australian oil and gas industry, while Malone *et al.*, (1993) found no significant statistical relation between auditor and voluntary reserve disclosure in the United States oil and gas industry. A study conducted by Tan *et al.* (1990) on companies in Malaysia also found no support that audit firms influence the disclosure strategies. The hypothesis is not accepted.

H12: Composition of Board of Directors: This variable was statistically significant at the 2% level was of the predicted sign. This result is in line with Gibbins *et al.*, (1992) and Haniffa and Cooke, 2000) and the hypothesis is accepted.

H13: Dividend: This variable was not statistically significant and as it was positive is not of the expected sign. The postulated negative association between bank dividend payments and the level of disclosure was based on an argument that dividends had information content which might substitute for the information contained in financial statements as managers can pay shareholders dividends to alleviate their concern about agency problems (Archambault and Archambault, 2003).

The performance of this variable was disappointing and may reflect poor specification. Alternative specifications which may perform better are dividend pay-out rate unlagged or lagged, annual change in dividend, or change in dividend yield. These versions of the variable may be used in developments of this research. The hypothesis is not accepted.

I now consider the results of the application of the general model to the mandatory elements of the disclosure index.

7.4.2 Determinants of the Mandatory Elements of the Total Disclosure Index

The model described in Equation 7.1 was applied with Y as the score based on the (101) mandatory elements in the total disclosure index score for all banks. The overall performance of this model (Model 2) is reported in Table 7.11 with Table 7.12 showing the coefficient values and associated statistics for Model 2. Table 7.12 reports that overall the multiple regression model is significant (at $P < 0.005$) with an adjusted coefficient of determination (R squared) which indicates that 19% of the variation in the dependent variable mandatory disclosures is explained by variations in the independent variables, representing a significant reduction in the explanatory power of the model.

Table 7.11
Overall Performance for Model 2

R	R Square	Adjusted R Square	Standard. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.688(a)	0.474	0.189	4.88655	0.474	1.663

Note: (a) Predictors: (Constant), ASINPLAC, EXCHANGE, HISTORY, AUDIT, DIVERSIT, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA.

From Table 7.12 I note that the coefficients representing bank size (measured by log of assets) reduces in significance to 12%, and the market discipline variable NPA becomes insignificant while its partner variable and CAR remains statically significant at the 2% level (and again with a negative sign). Of the other variables only profitability variable ROA (again with contrary sign) and the board composition variable are statistically significant at a conventionally acceptable level. Since the dependent variable is based on mandatory items the general expectation is that all banks should adhere strictly to the

disclosure of the items. I have noted earlier in the chapter that there is a mean disclosure deficiency in the mandatory items of approximately 10 percentage points from the maximum mandated disclosures which may be explained by lax regulatory supervision or poor internal compliance or control of compliance. In this context the presence of statistically significant variables of the expected signs (both positive) on size and board composition supports this interpretation if size is associated with political visibility (and hence political costs of non-compliance) and if active and dominant non-executive directors with reputational capital are associated with regulatory compliance. The negative sign on profitability was again not as predicted and may be consistent with a defensive approach by unprofitable banks through increased disclosure.

Table 7.12
Coefficient Values and Associated Statistics for Model 2

	Unstandardised		Standardised	T	Significance	Collinearity	
	Coefficients		Coefficients	Statistic	.	Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	80.151	8.341		9.609	.000		
LOGASSE	1.297	.796	.369	1.630	.116	.429	2.333
AGE	-.015	.036	-.101	-.417	.680	.376	2.657
HISTORY	-1.721	2.092	-.146	-.823	.419	.698	1.433
DIVERSIF	1.625	2.249	.148	.723	.477	.520	1.923
ROA	-355.995	191.836	-.614	-1.856	.076	.200	4.999
NPA	-73.709	55.680	-.491	-1.324	.198	.159	6.276
EXCH	.486	1.156	.114	.421	.678	.301	3.324
CAR	-1.912	.718	-.525	-2.662	.014	.563	1.775
BOD	11.396	5.879	.397	1.938	.064	.524	1.909
DIVIDEND	6.640	5.376	.273	1.235	.229	.450	2.221
SUBSIDIA	-.179	.293	-.162	-.611	.547	.311	3.214
AUDIT	.642	1.711	.059	.375	.711	.880	1.136
AINPLACE	2.494	2.508	.204	.994	.330	.520	1.922

Note: (a) Dependent Variable: MANDAOTR

7.4.3 Determinants of the Voluntary Elements of the Total Disclosure Index

The model described in Equation 7.1 was next applied with Y as the score based on the (83) voluntary elements in the total disclosure index score for all banks. The overall performance of this model (designated Model 3) is reported in Table 7.13 with its companion Table 7.14 showing the coefficient values and associated statistics for Model 3. Table 7.13 reports that overall the multiple regression model is significant (at $P < 0.005$) with an adjusted R squared of 0.504 which indicates that approximately 50% of the variation in the dependent variable voluntary disclosure score is explained by variations in the independent variables. This is the best explanatory performance of the three models tested so far.

Table 7.13
Overall Performance for Model 3

R	R Square	Adjusted R Square	Standard Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.824(a)	0.678	0.504	5.49322	0.678	3.892

Note: (a): Predictors: (Constant), ASINPLAC, EXCHANGE, HISTORY, AUDIT, DIVERSIT, DIVIDEND, BOARD, CAR, AGE, ROA, ASSETS, SUBSIDIA, NPA

Table 7.14
Coefficient Values and Associated Statistics for Model 3

	Unstandardised Coefficients		Standardised Coefficients	T Statistics	Significance	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-3.690	9.377		-.393	.697		
LOGASSE	3.179	.895	.628	3.553	.002	.429	2.333
AGE	.068	.041	.314	1.666	.109	.376	2.657
HISTORY	1.614	2.352	.095	.686	.499	.698	1.433
DIVERSIF	5.305	2.528	.337	2.099	.047	.520	1.923
ROA	-608.884	215.653	-.731	-2.823	.009	.200	4.999
NPA	-229.897	62.593	-1.065	-3.673	.001	.159	6.276
EXCH	2.920	1.300	.474	2.247	.034	.301	3.324
CAR	-1.992	.808	-.380	-2.466	.021	.563	1.775
BOD	11.379	6.609	.275	1.722	.098	.524	1.909
DIVIDEND	-.069	6.043	-.002	-.011	.991	.450	2.221
SUBSIDIA	-.870	.329	-.549	-2.645	.014	.311	3.214
AUDIT	.276	1.924	.018	.143	.887	.880	1.136
AINPLACE	4.772	2.819	.272	1.693	.103	.520	1.922

Note: Dependent variable: VOLDISC

Of the individual independent variables those which are statistically significant are: size (at 1%), geographic diversification (5%), profitability (1%), market discipline NPS version (1%), market discipline CAR (2%), multiple stock exchange listing (at 3%), composition of board of directors (at 10%), complexity of business (at 1%), and assets-in-place (at 10%). The variable age of bank is significant at 11%. The sign for size is positive as expected, as are those for geographic diversification, multiple stock exchange listing, composition of board of directors, and assets-in-place, indicating acceptance of the hypotheses associated with those variables. Of the other statistically significant variables signs contrary to expectation were obtained for the variables on profitability (as with Models 1 and 2), the two market discipline variables, and complexity of business indicating that the hypotheses associated with those variables cannot be accepted, subject to the discussions of underlying relations already presented.

7.5 Comparative Position of Indian Accounting Standards and International Accounting Standards

International Accounting Standards (IASs) were issued by the International Accounting Standards Committee (IASC) from 1973 to 2000. The International Accounting Standard Board (IASB) replaced the IASC in 2001. Since then, the IASB has amended some IASs, has proposed to replace some IASs with new International Financial Reporting Standards (IFRSs), and has adopted or proposed certain new IFRSs on topics for which there was no previous IAS. Through committees, both the IASC and the IASB also have issued Interpretations of Standards. Financial statements may not be described as complying with IFRSs unless they comply with all of the requirements of each applicable standard and each applicable interpretation. The restructuring of the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions

(IOSCO) acceptance of the IASB's "core set of standards" for the purpose of cross-border listing have improved the acceptability of IAS/IFRS within India.

The Institute of Chartered Accountants of India (ICAI), as the premier accounting body in the country, has taken on responsibility for leading the development and issue of accounting standards. For many years this has been through the agency of the Accounting Standards Board (ASB), established on 21st April 1977. Thirteen accounting standards were issued in India between 2000 and 2004, as compared to 16 standards issued from 1977 to 1999. The accounting standards issued in India since 2000 are frequently referred to as the "new accounting standards".

Some of the new accounting standards came to be issued in view of need expressed by SEBI and the ICAI responded by issuing new standards and as a consequence Indian accounting standards are becoming closer to IAS/IFRS than was the case until the 1990s. The new accounting standards cover several complex recognition as well as disclosure issues, such as segment reporting, leases, deferred taxes, consolidated financial statements, intangible assets, and impairment of assets. These standards cover matters for which there were mostly no prior pronouncements. As a result, they have tended to follow the IASB promulgations more closely than the previous generation of standards. Nevertheless, there remain substantial differences between some of the new accounting standards and the corresponding IASB standards.

An element in India's movement towards accepting the globalisation of accounting standards is the adoption in some cases of the benchmark treatment rather than the allowed alternative treatment in the relevant IFRS. For example, when AS 11 dealing with the effects of foreign exchange rates was revised in 2003, the ASB decided to adopt

the international benchmark treatment that requires recognition in the current period of all exchange differences arising from transactions. The alternative treatment that allows carrying the additional liability arising from a severe devaluation as part of the cost of the related fixed asset was not accepted. This was despite the fact that the Companies Act requires adjusting the cost of fixed assets for exchange differences arising from foreign exchange liabilities related to acquisition of fixed assets.

7.5.1 The Differences between Indian Accounting Standards and IAS/IFRS

As noted above the differences between Indian accounting standards and IAS/IFRS have been narrowing, especially in the case of standards issued since the late 1990s. Some of the remaining differences are attributable to the need for conformity with the Companies Act. Some others exist because there is no corresponding Indian standard on the subject (e.g., financial instruments and business combinations). A general perception is that financial reporting practices have improved over recent years; however, significantly strengthened enforcement mechanisms are needed to further improve the quality of corporate financial reporting (World Bank 2004). Some of the new accounting standards are far reaching in their impact on firms' balance sheets and income statements and are therefore expected to have significant economic consequences. Indian accounting standards are gradually moving towards IAS/IFRS under the forces of globalization of Indian business. Some commentators have stated that India should adopt IAS/IFRS completely in order to convey to the outside world that the country's accounting standards are in line with the best international practices.

The Council of the ICAI has announced a plan to converge Indian accounting standards with IFRSs. However, the ICAI noted that it may make modifications to IFRSs to reflect "the Indian conditions". The new standards will be effective for accounting periods

beginning on or after 1 April, 2011. They would be required for all listed companies as well as banks, insurance companies, and large-sized entities. Government approval of the plan is required. (www.iasplus.com). The ICAI has set up a task force to explore the possibility of adopting all IFRSs in full, without modification, as Indian standards. The 11-member task force is chaired by S C Vasudeva, chairman of ICAI's Accounting Standard Board. It will develop a concept paper on adoption of IFRSs in India.

The following comparison has been made between Accounting Standards issued by ICAI and recent version of IFRS/IAS in terms of level of level and quality of the disclosures required:

AS 1/ IAS 1: Disclosure of Accounting Policies:

IAS 1, *inter alia*, deals with overall considerations, including fair presentation, off-setting, comparative information. On the other hand, AS 1 does not deal with these aspects in India. Also IAS 1 prescribes minimum structure of financial statements and contains guidance on related issues e.g. current liabilities. AS 1 does not prescribe any minimum structure.

AS 3/IAS 7: Cash Flow Statements

IAS 7 prohibits separate disclosure of extraordinary items in Cash Flow Statements. On the other hand, AS 3 mandates such disclosure in India. IAS 7 requires additional disclosure of cash payments by a lessee relating to finance lease under Financing Activities. No such disclosures required under AS 3.

AS 4/ IAS 10: Contingencies and Events Occurring after the Balance Sheet Date

IAS 10 provides that proposed dividends should not be shown as a liability. In contrast, AS 4 specifically requires such disclosure as the same is mandated by statutory requirements under the Companies Act. IAS 10 also requires disclosure of contingent liability to be updated in the light of new information received after the balance sheet date. However, AS 4 requires adjustments to figures stated in financial statements for events occurring after the balance sheet date, if such events relate to conditions existing at the balance sheet date.

As 17/ IAS14: Segment Reporting:

IAS 14 prescribes treatment of revenue, expenses, profit/loss, assets and liabilities in relation to Associates and Joint Ventures in consolidated financial statements. AS 17 is silent on the aspect of treatment in consolidated financial statements.

AS 18/ IAS 24: Related Party Disclosures:

The definition of related party under IAS 24 includes Post Employment Benefit Plans (e.g. gratuity fund, pension fund) of the enterprise or of any other entity, which is a related party of the enterprise. AS 18 does not include this relationship. IAS 24 requires compensation to key management person to be disclosed by category, including share-based payments. AS 18 does not specifically cover indirect authority and responsibility.

AS 20/ IAS 33: Earnings per Share (EPS):

IAS 33 requires separate disclosure of basic and diluted EPS for continuing operations and discontinued operations. AS 20 does not requires any such separate computation or disclosure.

AS 21/ IAS 21: Consolidated Financial Statements (CFS):

Under IAS 27 it is mandatory to prepare Consolidated Financial Statements and an entity should prepare separate financial statements in addition to Consolidated Financial Statements only if local regulations so require. Under AS 21, it is not mandatory to prepare Consolidated Financial Statements.

AS 25/ IAS 34: Interim Financial Reporting:

Under IAS 34, the minimum components of the Interim Financial Report includes a statement showing changes in equity. No such disclosure is required under AS 25.

7.6.1 Conclusions

This chapter has provided empirical results on the levels of disclosure achieved by individual banks on the total disclosure index and both its mandatory and voluntary components. These results show variations between public and private sector banks in relation to the three forms of the disclosure index. They also show evidence of a mean disclosure deficiency in the mandatory items of approximately 10 percentage points (with variations between public and private banks) from the maximum mandated disclosures. Combining this with the results of the regression analysis presented later in the chapter I consider that this may be explained by lax regulatory supervision or poor internal compliance or control of compliance. The presence of statistically significant variables of expected signs (both positive) on size and board composition supported this interpretation if size was judged to be associated with political visibility and political costs of non-compliance with mandated disclosures and if active and dominant non-executive directors protected their reputational capital by seeking to enforce regulatory compliance. The chapter also presented regression analyses using the general Equation 1 which was applied to the total disclosure index and both its mandatory and voluntary components in

turn. This produced strong results in terms of adjusted R squared for model 1 (total disclosure) and Model 3 (voluntary disclosure) but relatively poor explanatory performance for mandatory disclosure (Model 2). Detailed reviews of the hypotheses were provided in relation to Model 1 and other comments made in relation to the results for Models 2 and 3. In model 2 the coefficients representing bank size reduce in significance from its value in Model 1 and the market discipline variable NPA became insignificant whilst its partner variable CAR remained statically significant and appeared again with a negative sign. Of other variables only profitability (again with contrary sign) and the board composition variable were statistically significant at a conventionally acceptable levels. As noted above since the dependent variable in Model 2 was based on mandatory items our general expectation was that all banks would adhere strictly to the disclosure of such items. The negative sign on profitability was again not as predicted and may be consistent with a defensive approach by unprofitable banks through increased disclosure. Model 3 produced an adjusted R squared of 0.504 which indicated the best explanatory performance of the three models tested thus far. In Model 3 the individual independent variables which were statistically significant were size (at 1%), geographic diversification (5%), profitability (1%), market discipline NPS version (1%), market discipline CAR (2%), multiple stock exchange listing (at 3%), composition of board of directors (at 10%), complexity of business (at 1%), and assets-in-place (at 10%). The sign for size was positive as expected, as were the signs for geographic diversification, multiple stock exchange listing, composition of board of directors, and assets-in-place, indicating acceptance of the hypotheses associated with those variables. Of the other statistically significant variables signs contrary to expectation were obtained for the variables on profitability (as with Models 1 and 2), the two market discipline variables, and complexity of business indicating that the hypotheses associated with those variables

could not be accepted, subject to the discussions of underlying relations presented in the chapter.

Indian accounting standards and corporate governance requirements are now more in line with international practices. The recent developments can be attributed to the operation of economic forces arising from capital, product market and labour market pressures and to regulatory initiatives in response to overseas developments, such as the East Asian Crisis and SOX. Foreign financial institutions and listing in international stock exchanges are playing a major role in speeding the pace of raising Indian standards to international levels. India is still in the early stages of its involvement in the globalization of accounting standards. Mere adoption of superior accounting and disclosure standards will not raise the quality of Indian financial reporting. Creating a complementary institutional framework that, among others, facilitates cost effective private litigation by shareholders is critical.

I now turn to the application of the general model to disclosures on corporate governance in the following chapter.

CHAPTER EIGHT

BANK CORPORATE GOVERNANCE DISCLOSURES: LEVELS AND VARIATIONS IN RELATION TO FIRM-SPECIFIC DETERMINANTS

8.1 Introduction

This chapter presents the empirical results of the research in relation to levels of bank disclosures concerned specifically with corporate governance and relates these disclosures to firm-specific determinants of variations in corporate governance disclosure. As with the results of the previous chapter I shall go on to seek to assess the standard of financial reporting of Indian banking companies but focusing specifically on what was described in chapter six as a key aspect of modern business activity and policy concern, namely, corporate governance. As with Chapter Seven I shall also consider determinants of variations in corporate governance disclosures.

I discussed aspects of corporate governance both generally and in relation to Indian experience in Chapter Six (see section 6.2.11 in particular). Corporate governance for banks is particularly important given the economic significance of the banking sector in general and for growth and development in particular. Corporate governance in the financial sector of economies has received renewed attention in recent times (Mallin et al., 2005; Hackethal et al., 2005; Das and Ghose, 2004; and Arun and Turner, 2003). Within the broad ambit of the financial sector it is the banking sector that has been the main focus of attention of academics and policy-makers (Marcey and O' Hara, 2003; and Basel Committee on Banking Supervision, 1999) and India is no exception to this observation (Bhide et al., 2001). According to Levine (2003) and as discussed in earlier

chapters banks have two related characteristics that suggest benefits from a separate analysis of aspects of the corporate governance of banks. Firstly, banks are generally more opaque than non-financial firms and this opacity is likely to apply to their internal governance as to other aspects of activity. Secondly, banks are frequently very heavily regulated and such regulation may extend to their corporate governance in addition. Thus, combining these arguments I may note that to improve corporate governance of financial intermediaries, especially banks, policy-makers who already heavily regulate the sector may seek to enhance the ability and incentives of creditors and other market participants to monitor banks (Caprio and Levine, 2002, p.23) as the sector is characterised by information asymmetries (Mallin et al., 2005).

In the context of Indian I may note that the term 'corporate governance' remained little known until 1993, when as observed in an earlier chapter the issue came to the fore as a result of three scandals that occurred between 1990 to 1994 (see Goswami, 2003). Thereafter, two major corporate governance initiatives were launched. The first was taken by the Confederation of Indian Industry (hereafter the CII), a premier industry association (Monga, 2004, p.123), and the second was established by the Securities and Exchange Board of India (SEBI). In December 1995, the CII set up a high-powered committee under the chairmanship of Mr. Rahul Bajaj to prepare a comprehensive voluntary code of corporate governance for listed companies. A final draft report was prepared in April 1997 and the almost unedited version of which was released in April 1998 as *Desirable Corporate Governance: A Code*. Until the end of 2000, the CII code was the only guideline for corporate governance in India. In 1999, the SEBI established the "Kumar Mangalam Birla Committee" under the chairmanship of Kumar Mangalam Birla. The SEBI board accepted and ratified the key recommendations of this committee and informed all stock exchanges in February 2000 proposing that a new clause be

incorporated in their listing agreements. The new clause (Clause 49) was entitled 'Corporate Governance' and contained eleven sections dealing with various corporate governance issues such as the Board of Directors, Audit Committee, and Remuneration of Directors and in section VI required that there be a separate section on Corporate Governance in the Annual Reports of listed companies. Within this framework, the SEBI provided a suggested list of mandatory items to be disclosed in this Corporate Governance Report

The analysis presented here will seek to establish the extent to which Indian banking companies comply with the rules and regulations which govern them in relation to disclosure on corporate governance and also to determine whether corporate attributes have an influence on the extent of disclosures in relation to corporate governance. As with the analysis of the total general disclosure index in chapter 9 above I consider levels of corporate governance disclosure by further decomposing an overall corporate governance index into mandatory and voluntary elements.

The chapter is organised as follows. Section 8.2 describes the content and structure of the corporate governance disclosure index which has been constructed for analysis; Section 8.3 analyses data on levels of disclosure on corporate governance by the sample banks; Section 8.4 provides descriptive and forensic statistics in relation to the variables used in the models applied to corporate governance disclosure (the correlation matrix and analysis of multi-collinearity); Section 8.5 presents the results of the modelling of the behaviour of the disclosure indices for corporate governance items, incorporating analysis of both mandatory and voluntary items of information; and Section 8.6 contains a discussion of conclusions.

8.2 The Corporate Governance Disclosure Index

The general disclosure index analysed in the previous chapter contained 55 items on corporate governance spread across both mandatory and voluntary elements and as detailed in Appendix 5 and Appendix 6. To analysis corporate governance disclosures directly the mandatory and voluntary elements of corporate governance disclosure were extracted from the general disclosure index and combined as the basis for a single index. The list of corporate governance items initially produced was extended marginally by the inclusion of other items indicating the disclosure of risk management policies and an item covering the disclosure of a MD and A report as part of the annual accounts on the grounds that these were significant elements in reporting on corporate governance. The components of the resulting index are set out in Appendix 7. The annual reports of the sample banks were reviewed specifically for corporate governance disclosures against this new index and scores accumulated for all the sample banks on an equivalent basis to that adopted for the analysis of the general disclosure index of Chapter Nine. The results on levels of corporate governance disclosure by sample banks are reported and analysed in the following section.

8.3 Results on Levels of Corporate Governance Disclosure by Sample Banks

Performance by the individual sample banks on the total corporate governance disclosure index is presented in Table 8.1 and Table 8.2 presents an overall statistical summary of scores on the total corporate governance disclosure index.

From Table 8.2 I may note that for all banks the range of corporate governance scores is from lowest 36 (63.15% of the 57 items in the index) to highest 51 (89.47%) with a mean score of 39.72 (71.33%). The standard deviation of scores was 3.17. When the banks are divided into public and private sector sub-samples private sector banks on average scored

marginally higher with a mean of 41.10 (71.83 %) against a mean of 40.39 (70.85%) for public sector banks. The scores for public sector banks exhibited a lower dispersion both in terms of range of disclosure score (46-36 versus 51-36) and standard deviation (2.45 versus 3.69). The same patterns are of course shown in the relative percentage scores. In relation to the performance of individual banks a private sector bank was ranked first by level of disclosure, (Global Trust Bank Ltd) followed by another private sector institution (IDBI Bank Ltd). The lowest score (36) was obtained by four different banks, one in the public sector (State Bank of Mysore) and three in the private sector (Federal Bank Ltd, United Western Bank Ltd, and Bank of Punjab Ltd).

**Table 8.1 Performance on Total Corporate Governance Disclosure
Index by Sample Banks**

Bank	Score of Total Corporate Governance Disclosure Index (57 items)	Percentage of Items Disclosed (% of maximum 57 items)
Public Sector Banks		
1. Allahabad Bank	41	71.92
2. Andhra Bank	40	70.17
3. Bank of Baroda	46	80.70
4. Bank of India	43	75.43
5. Canara Bank	43	75.43
6. Corporation Bank	43	75.43
7. Dena Bank	39	68.42
8. Indian Overseas Bank	39	68.42
9. Oriental Bank of Commerce	42	73.68
10. Punjab National Bank	41	71.92
11. Syndicate Bank	40	70.17
12. Union Bank of India	39	68.42
13. Vijaya Bank	38	66.60
14. State Bank of India	39	68.40
15. State Bank of Bikaner & Jaipur	37	64.91
16. State Bank of Indore	39	68.42
17. State Bank of Mysore	36	63.15
18. State Bank of Travancore	42	73.68
Private Sector Banks		
19. Bank of Rajasthan Ltd.	44	77.19
20. City Union Bank Ltd.	42	70.17
21. Dhanalakshmi Bank Ltd.	40	70.18
22. Federal Bank Ltd.	36	63.15

23. ING Vysya Bank Ltd.	40	70.17
24 Jammu & Kashmir Bank	40	70.17
25. Karnataka Bank Ltd.	41	71.92
26. Karur Vysya Bank Ltd.13	39	68.42
27. Lakshmi Vilas Bank Ltd.	38	66.67
28. South Indian Bank Ltd.	42	70.17
29. United Western Bank Ltd.	36	63.15
30. Bank of Punjab Ltd.	36	63.15
31. Centurion Bank Ltd.	40	70.17
32. Global Trust Bank Ltd.	51	89.47
33. HDFC Bank Ltd.	40	70.17
34. ICICI Bank Ltd.	44	77.19
35. IDBI Bank Ltd.	47	82.45
36. Indusland Bank Ltd.	43	75.43
37. Kotak Mahindra Bank	40	70.17
38. UTI Bank Ltd.	43	75.43

Table 8.2 Statistical Summary of Scores on Total Corporate Governance Disclosure Index

	All Banks	Public Sector Banks	Private Sector Banks
Mean absolute score	39.72	40.39	41.10
Maximum absolute score	51	46	51
Minimum absolute score	36	36	36
Standard deviation of absolute	3.17	2.45	3.69
Mean percentage score	71.33	70.85	71.83
Maximum percentage score	89.47	80.70	89.47
Minimum percentage score	3.15	63.15	63.15
Standard deviation of percentage score	5.80	4.67	6.63

Having considered the overall levels and patterns of disclosure on the total corporate governance index I now turn to the disaggregation of the total index into mandatory and voluntary items. Performance by the individual sample banks on the mandatory component of the total disclosure index is presented in Table 8.3 with Table 8.4 presenting a statistical summary of scores on the mandatory items of the index. From Table 8.4 I can observe that for all banks the range of scores is from lowest 33 (71.73% of the 46 items in the index) to highest 45 (97.83 %) with a mean score of 37.71 (81.83%). The standard deviation of absolute scores was 2.54. When the banks are divided into public and private sector sub-samples private sector banks were found on average to score marginally higher with a mean of 38.35 (83.20%) against a mean of 37 (80.31 %) for public sector banks. The scores for public sector banks showed a lower dispersion both in terms of range of disclosure score (42-34 versus 45-33) and standard deviation (2.06 versus 2.88) when compared to private sector banks. The same patterns are apparent in the relative percentage statistics. When the performance of individual banks is considered a private sector bank were ranked first equal by level of disclosure, (Global Trust Bank Ltd). The lowest score was obtained by private sector bank (Federal Bank Ltd).

As with the total disclosure index examined in Chapter Seven these results are in line with an expectation that mandatory levels of corporate governance disclosure will be high but the levels of mean score for the mandatory items are all well below 100% which is the expectation for mandatory disclosures in a regime of high compliance. Interestingly, mean compliance levels for mandatory corporate governance disclosures are below those for the total disclosure index items for all banks (81.83% for corporate governance items against 88.45% for all items) with public sector banks performing worse than private banks on the disclosure of mandatory corporate governance items (a mean of 80.31% of the index compared to 83.20%). Since the means are smaller for mandatory corporate

governance disclosures than for the mandatory elements of the total disclosure index I may conclude that levels of compliance are poorer and monitoring are weaker and that this is especially marked for public sector institutions. If I turn to the performance of the sample banks on voluntary corporate governance disclosures I may consider the relative performances of the two sub-samples and gain further insights into disclosure performance in this area.

Performance by the individual sample banks on the voluntary components of the total corporate governance disclosure index is presented in Table 8.5 and Table 8.6 with Table 8.6 presenting the statistical summary of the scores on the mandatory items in both absolute terms and as percentages. From Table 8.6 I note that for all banks the range of scores is from lowest one (1) (9.09% of the eleven items in the index) to highest six (6) (54.54%) with a mean score of 3.05 (27.75%). The standard deviation of absolute scores across all banks was 1.33 (and of percentage scores 12.13). When the banks are divided into public and private sector sub-samples private sector banks on average scored lower with a mean of 2.75 (25.00%) against a mean of 3.39 (30.81%) for public sector banks, thus reversing the relative positions for mandatory disclosures of corporate governance items, interestingly the same relative performances as for the total disclosure index. The scores for public sector banks exhibited a marginally smaller degree of dispersion in terms of range of disclosure score (5-1 versus 6-1) and showed a lower standard deviation (1.09 versus 1.48). The same patterns are evident in the relative percentage statistics. When the performance of individual banks is considered the same two private sector banks (Global Trust Bank Ltd and IDBI Bank Ltd) were the upper outliers in the total sample, with two private sector banks (HDFC Bank Ltd, United Western Bank Ltd, Bank of Punjab Ltd) and one public sector bank (State Bank of Mysore) being the joint poorest voluntary disclosers of corporate governance information. This performance reflects that

on the general index of voluntary items where three private banks shared the lowest voluntary disclosure performance (Karnataka Bank Ltd, United Western Bank Ltd., and Centurion Bank Ltd.).

The results for the analysis of voluntary disclosure are mixed in relation to expectations. Overall levels of voluntary disclosure are relatively low with only the best disclosers reaching 50% or better of items in the voluntary part of the index. Private banks on average disclose less of the voluntary items in the index than do public sector banks and the sub-sample of private banks displays greater dispersion when measured by the standard deviation of the scores. As expected, mean levels of voluntary disclosure are significantly below those of mandatory disclosure for all banks together (illustrated here as percentage scores of 27.75% versus 81.83%) and for both the public sector sub-sample (30.81% versus 80.31%) and the private sector sub-sample (25.00% versus 83.20%) and show more dispersion (illustrated here as standard deviations of percentage scores) for all banks (12.13 versus 5.47) and both public sector banks (9.93 versus 4.41) and private banks (13.47 versus 6.06).

Table 8.3.
Performance on Mandatory Elements of Total Corporate Governance Disclosure Index by Sample Banks

Bank	Score of Mandatory Items in Total Disclosure Index (46 items)	Percentage of Mandatory Items Disclosed (% of maximum 46 items)
Public Sector Banks		
1. Allahabad Bank	38	82.05
2. Andhra Bank	35	76.08
3. Bank of Baroda	42	91.30
4. Bank of India	38	82.05
5. Canara Bank	38	82.05
6. Corporation Bank	39	84.78
7. Dena Bank	36	78.26
8. Indian Overseas Bank	37	80.43
9. Oriental Bank of Commerce	38	82.05
10. Punjab National Bank	39	84.78
11. Syndicate Bank	37	80.43
12. Union Bank of India	36	78.26
13. Vijaya Bank	35	76.08
14. State Bank of India	35	76.08
15. State Bank of Bikaner & Jaipur	34	73.91
16. State Bank of Indore	35	76.08
17. State Bank of Mysore	35	76.08
18. State Bank of Travancore	39	84.78
Private Sector Banks		
19. Bank of Rajasthan Ltd.	41	88.13
20. City Union Bank Ltd.	40	86.95
21. Dhanalakshmi Bank Ltd.	36	78.06
22. Federal Bank Ltd.	33	71.73
23. ING Vysya Bank Ltd.	38	82.05
24 Jammu & Kashmir Bank	38	82.05

25. Karnataka Bank Ltd.	39	84.78
26. Karur Vysya Bank Ltd.13	36	78.26
27. Lakshmi Vilas Bank Ltd.	36	78.26
28. South Indian Bank Ltd.	37	80.43
29. United Western Bank Ltd.	35	76.08
30. Bank of Punjab Ltd.	35	76.08
31. Centurion Bank Ltd.	38	82.05
32. Global Trust Bank Ltd.	45	97.82
33. HDFC Bank Ltd.	39	84.78
34. ICICI Bank Ltd.	41	89.13
35. IDBI Bank Ltd.	41	89.13
36. Indusland Bank Ltd.	40	86.95
37. Kotak Mahindra Bank	38	82.05
38. UTI Bank Ltd.	41	89.13

Table 8.4
Statistical Summary of Scores on Mandatory Elements in Total Corporate Governance Disclosure Index

	All Banks	Public Sector Banks	Private Sector Banks
Mean absolute score	37.71	37	38.35
Maximum absolute score	45	42	45
Minimum absolute score	33	34	33
Standard deviation of absolute	2.54	2.06	2.88
Mean percentage score	81.83	80.31	83.20
Maximum percentage score	97.83	91.30	97.82
Minimum percentage score	71.73	73.91	71.73
Standard deviation of percentage score	5.47	4.41	6.06

Table 8.5
Performance on Voluntary Elements of Total Corporate Governance Disclosure Index
by Sample Banks

Name of Bank	Score of Voluntary Items in Total Disclosure Index (11 items)	Percentage of Voluntary Items Disclosed
Public Sector Banks		
1. Allahabad Bank	3	27.27
2. Andhra Bank	5	45.45
3. Bank of Baroda	4	36.36
4. Bank of India	5	45.45
5. Canara Bank	5	45.45
6. Corporation Bank	4	36.36
7. Dena Bank	3	27.27
8. Indian Overseas Bank	2	18.18
9. Oriental Bank of Commerce	4	36.36
10. Punjab National Bank	2	18.18
11. Syndicate Bank	3	27.27
12. Union Bank of India	3	27.27
13. Vijaya Bank	3	27.27
14. State Bank of India	4	36.36
15. State Bank of Bikaner & Jaipur	3	27.27
16. State Bank of Indore	4	36.36
17. State Bank of Mysore	1	9.09
18. State Bank of Travancore	3	27.27
Private Sector Banks		
19. Bank of Rajasthan Ltd.	3	27.27
20. City Union Bank Ltd.	2	18.18
21. Dhanalakshmi Bank Ltd.	4	36.36
22. Federal Bank Ltd.	3	27.27
23. ING Vysya Bank Ltd.	2	18.18
24. Jammu & Kashmir Bank	2	18.18
25. Karnataka Bank Ltd.	2	18.18
26. Karur Vysya Bank Ltd.	3	27.27
27. Lakshmi Vilas Bank Ltd.	2	18.18
28. South Indian Bank Ltd.	5	45.45

29. United Western Bank Ltd.	1	9.09
30. Bank of Punjab Ltd.	1	9.09
31. Centurion Bank Ltd.	2	18.18
32. Global Trust Bank Ltd.	6	54.54
33. HDFC Bank Ltd.	1	9.09
34. ICICI Bank Ltd.	3	27.27
35. IDBI Bank Ltd.	6	54.54
36. Indusland Bank Ltd.	3	27.27
37. Kotak Mahindra Bank	2	18.18
38. UTI Bank Ltd.	2	18.18

Table 8.6

Statistical Summary of Scores on Voluntary Elements of Total Corporate Governance Disclosure Index

	All Banks	Public Sector Banks	Private Sector Banks
Mean absolute score	3.05	3.39	2.75
Maximum absolute score	6	5	6
Minimum absolute score	1	1	1
Standard deviation of absolute score	1.33	1.09	1.48
Mean percentage score	27.75	30.81	25.00
Maximum percentage score	54.54	45.45	54.54
Minimum percentage score	9.09	9.09	9.09
Standard deviation of percentage score	12.13	9.93	13.47

8.4 Modelling the Determinants of Corporate Governance Disclosure

The determinants of corporate governance disclosure were tested using two versions of the general form of the model utilised in Chapter Seven based on the specification of

variables in Chapter Six. OLS regression models were fitted to data for the sample banks in order to assess the effect of each independent variable on the total corporate governance disclosure index, and in turn its mandatory and voluntary components. First a reduced version of the general form of the model based on Equation 7.1 was applied (i.e. using nine explanatory variables) then the full form of the model using all eleven independent variables was applied. The analysis of characteristics of independent variables is contained in Table 7.7 in the previous chapter, presenting means and standard deviations for the variables, with its accompanying Table 7.8 showing correlations between independent variables. I now present the results of the tests of the above two versions general model on the total corporate governance disclosure index and in turn its mandatory and voluntary components.

8.4.1 Determinants of the Total Corporate Governance Disclosure Index (Nine Independent Variables)

In order to examine the effect of corporate attributes on the level of corporate governance disclosure, elements of the model developed and used in chapter nine were utilized as follows. In the presentation here briefer discussions will be presented of variables and associated hypotheses presented in chapter Seven. In our analyses of versions of the corporate governance disclosure index the following variables were initially employed.

Size of the Bank

The size of the bank is a potentially important variable to establish an association with the extent of corporate governance disclosure. As noted in chapter nine above most researchers find a close relationship between these two variables both in developing and developed countries a number of reasons have been advanced in the literature to justify this relationship including large firms having resources and expertise necessary

for the production and publication of more sophisticated financial statements and therefore cause less disclosure non-compliance; smaller firms may feel that fuller disclosure will put them at a competitive disadvantage with larger; and larger firms have greater need for disclosure because their securities are typically distributed via more diverse networks of exchanges. A argues that these issues apply to corporate governance disclosures and therefore hypothesis that:

H14: *The level of corporate governance disclosure is positively associated with bank size*

Ownership

Ownership of a firm may influence disclosure. Previous studies such as Chau and Gray (2002) and Hossain et al. (1994) support this argument. Agency theory (Jensen and Meckling, 1976; Watts, 1977) suggests that where there is a separation of ownership and control of a firm, the potential for agency costs arises because of conflicts of interest between contracting parties. As a result, information disclosure is likely to be greater in widely held firms so that principals can effectively monitor that their economic interests are optimised and agents can signal that they act in the best interests of the owners. As our sample included two types of bank, i.e. public and private, there is a possibility to find differences in corporate governance disclosure. Public sector banks in India are closely monitored by the Government of India as it holds major ownership. Thus, the hypothesis is that:

H15: *Public sector banks are more compliant with disclosure requirements than private sector banks (as measured by mandatory disclosures) and will tend to make more extensive voluntary disclosures.*

Board Composition

Board composition might be an explanatory variable for corporate governance items because it may indirectly reflect the role of the non-executive directors on boards (Haniffa and Cook, 2002). Moreover, non-executive directors are seen as the check and balance mechanism in enhancing boards' effectiveness (Fama and Jensen, 1983; Brickley and James, 1987; Weisbach, 1988; Pearce and Zahra, 1992). The premise of agency theory is that boards are needed to monitor and control the actions of directors due to their opportunistic behaviour (Berle and Means, 1932; Jensen and Meckling, 1976). Mangel and Singh (1993) believe that outside directors have more opportunity for control and face a more complex web of incentives, stemming directly from their responsibilities as directors and augmented by their equity position. Others who also see the role of non-executive directors as monitors/controllers of management's performance and actions include Fama and Jensen (1983), Brickley and James (1987), Weisbach (1988), and Pearce and Zahra (1992). Additionally, outside directors may be considered to be decision experts (Fama and Jensen, 1983), may reduce managerial consumption of perquisites (Brickley and James, 1987), will not be intimidated by the CEO (Weisbach, 1988), and act as a positive influence over the directors' deliberations and decisions (Pearce and Zahra, 1992). I therefore hypothesise that:

H16: *Banks with a greater proportion of non-executive directors on the board will disclose more information on corporate governance and will be more compliant with mandatory disclosure requirements, and will tend to make more extensive voluntary disclosures than banks with a smaller number of non-executive directors on the board.*

Financial Performance

Past performance can affect the degree of disclosure (Khanna, et al., 2004). For example, profitable firms may be more willing to disclose information to outside

investors than less profitable firms. Most researchers have found a positive relationship between profitability and the extent of disclosure (Cerf 1961, Singhvi and Desai 1971, Belkaoui and Khal 1981, Wallace 1987, Wallace *et al* 1994, Wallace and Naser 1995, Raffournier 1995, Inchausti 1997, Hossain 1999 and Hossain, 2001). Banks, whether formally profit making institutions or not, are engaged in the kind of business where return is expected. The profit earning mechanism depends *inter alia* on how effectively banks conduct their lending and borrowing activities (Hossain, 2001). Previous studies have examined the impact of both accounting performance (Lang and Lundholm, 1993; Miller, 2002) and market performance (Khanna, et al., 2004) on levels of disclosure. I measure accounting performance as rate of return (ROA). In considering the nature of the activities of the banking business, ROA is an appropriate proxy for measuring financial performance of banks. There are two related reasons for the choice of this formula of the profitability variable. One is that an ROA variable is scaled to remove a size effect (using absolute net profit as the profitability variable and total assets as the demoninator scalling factor). The second is that ROA links to the mechanics of banking as financial intermediation (Hossain, 2001). Thus I hypothesise that:

H17: *There is a positive association between profitability and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*

Age

The extent of a company's disclosure may be influenced by its age, i.e. stage of development and growth (Owusu-Ansah, 1998). Owusu-Ansah (1998, p. 605)

pointed out three factors that may contribute to this phenomenon. Firstly, younger companies may suffer competition, secondly, the cost and the ease of gathering, processing, and disseminating the required information may be a contributory factor, and finally, younger companies may lack a track record on which to rely for public disclosure. Kakani et al. (2001) pointed out that newer and smaller firms, as result, take market in spite of disadvantages like lack of capital, brand names and corporation reputation with older firms. However, it is not possible to reach a conclusion that long-established banks can disclose more information or be more compliant than newly-established banks. This leads to the following hypothesis:

H18: *There is a positive association between bank age and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*

Complexity of Business

Haniffa and Cook (2002) argued that structural complexity has a significant influence in the extent of disclosure. The structural complexity requires a firm to have an effective management information system for monitoring purposes (Courtis, 1978; Cooke, 1989a) and the availability of such a system helps to reduce the cost of information per unit, thereby providing the expectation of higher disclosure. Here, structural complexity is defined as the actual number of subsidiaries for each sample bank. Thus, I hypothesise that:

H19: *There is a positive association between structural complexity and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*

Dividend Policy

Management can pay shareholders dividends to alleviate their concern about agency problems (Eastbrook, 1984). It is argued that dividends provide information to investors about the amount and timing of future cash flows (Miller and Rock, 1985). The information provided by dividends may substitute for other forms of corporate disclosure. This is especially true in instances where capital markets are less developed and/or subject to manipulation in the trading of securities (Previts and Bricker, 1994). India is not exceptional in this case. As a result, firms that pay large dividends may reduce corporate governance disclosures and be less compliant with mandatory disclosure requirements. It is therefore hypothesised that:

H20: There is a negative association between dividend payments and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.

Multiple listing

It is evident that companies listed beyond their domestic market or, listed on more than minimum listing requirements, may disclose more information (Choi and Mueller, 1984; Cooke, 1989; Gray et al., 1995) in order to comply with regulation and obtain funds from capital markets. Moreover, Cooke (1998) and Ferguson et al. (2002) report that firms that are quoted on several stock exchanges make more information disclosures. Indian banks need to list on at least three stock exchanges (Ministry of Finance, 1985). Thus it is hypothesised that:

H21: Banks that are listed on more exchanges than the minimum will make greater total corporate governance disclosures than banks listed on the

minimum number of exchanges (and positively with numbers of listing) and will have a greater level of compliance with mandatory disclosure requirements, and will have higher levels of voluntary corporate governance disclosures

Number of Auditors

Wallace et al. (1994) suggest that the contents of annual reports may be influenced by auditors. Agency theory holds that auditing helps to alleviate the interest conflicts between management and investors (Xiao et al., 2004). Generally, because they have more to lose from damage to their reputations, larger audit firms have a stronger incentive to maintain their independence and to impose more stringent and extensive disclosure standards (DeAngelo, 1981; Malone et al., 1993). Hence, larger auditors are more likely to be hired by managements with greater potential gains from external monitoring. This expectation is also consistent with signalling theory. The reasoning is that managers are cognizant of larger auditors' incentives to demand higher quality disclosure, and engagement of such auditors is a signal of their acceptance of such demands (Datar et al., 1991; Healy and Palepu, 2001). I argue that if a company that appoints more audit firms than the stipulated minimum will have a higher standard of disclosure and compliance. I hypothesise that:

H22: Banks with more auditors than the minimum stipulated will make greater total corporate governance disclosures than banks with the minimum number of stipulated auditors (and positively with numbers of auditors) and will have a greater level of compliance with mandatory disclosure requirements, and will have higher levels of voluntary corporate governance disclosures

The following regression model was used to investigate the relationships between corporate governance disclosure and the foregoing corporate attributes (independent variables) discussed above:

$$Y = \beta_i + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \epsilon_i$$

[Model 4]

Where, Y = disclosure index

X1 = total assets (proxy for size);

X2 = 1 if the bank belongs to the public sector; 0 if otherwise

X3 = Ratio of non-executive independent directors to total number of directors
on the board

X4 = ROA (proxy for profitability);

X5 = age of bank in years (proxy for age);

X6 = Actual number of subsidiaries

X7 = Dividend paid

X8 = Actual number of listings on stock exchanges

X9 = 1 if the number of auditors is in excess of the minimum; 0 if otherwise

This model was applied with the dependent variable as the disclosure score based on the (57) elements in the total corporate governance disclosure index score for all banks. The overall performance of this model (Model 4) is reported in Table 8.7 with Table 8.8 showing the coefficient values and associated statistics for Model 4.

Table 8.7
Overall Performance for Model 4 (Nine Independent Variables)

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.629(a)	0.396	0.202	4.88339	0.396	2.038

a Predictors: (Constant), AUDIT, BOARD, DIVIDEND, EXCH, ASSETS, SUBSIDIA, AGE, ROA, PUBVSPRI

Table 8.8
Coefficient Values and Associated Statistics for Model 4 (Nine Independent Variables)

	Unstandardised Coefficients		Standardised Coefficients	T Statistic	Significance.	Collinearity Statistics	
	B	Std. Error				Beta	Tolerance
(Constant)	63.709	7.930		8.034	0.000		
ASSETS	1.611	0.701	.454	2.299	0.029	.552	1.811
PUBVSPRI	-5.036	3.036	-.464	-1.659	0.108	.275	3.630
BOARD	-6.207	6.521	-.214	-.952	0.349	.425	2.352
EXCH	-.408	1.022	-.095	-.399	0.693	.385	2.600
DIVIDEND	.304	4.667	.012	.065	0.949	.596	1.678
SUBSIDIA	.266	0.224	.241	1.188	0.245	.523	1.912
AGE	.021	0.037	.138	.569	0.574	.366	2.735
ROA	-317.566	123.044	-.544	-2.581	0.015	.486	2.059
AUDIT	1.782	1.687	.163	1.056	.300	.904	1.106

a Dependent Variable: Total Disclosure Index

The model performed modestly, with the independent variables explaining only 20.20% of the variation of the total index of corporate governance disclosures. Lower adjusted R square statistics were reported by Wallace (1988) at 7%, Malone *et al.*, (1993) at 29%, and Hossain (1999) at 10%. Only two variables were statistically significant at acceptable levels (size at 2.9% and profitability proxied by return on assets at 1.5%). No other variable was significant at better than level better than 10%. Consequently I may accept hypotheses one and four and reject the other seven. The

two significant variables are commonly found as significant determinants of disclosure in studies but indicate either under-developed managerial behaviour towards disclosure decisions on corporate governance and/or deficiencies in the model. Two further tests were undertaken using the nine-variable estimator of model 4 and the results are briefly reported in the following two sections.

8.4.2 Determinants of the Mandatory Elements of the Total Corporate Governance Disclosure Index (Nine Independent Variables)

The explanatory variables of Model 4 were applied with the dependent variable as the score based on the (46) mandatory elements in the total corporate governance disclosure index score for all banks and the resulting model was designated Model 5. The overall performance of this model (Model 5) is reported in Table 8.9 with Table 8.10 showing the coefficient values and associated statistics for Model 5.

Table 8.9 Overall Performance for Model 5 (Nine Independent Variables)

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0630(a)	.4396	0.202	5.0216	0.367	1.876

a Predictors: (Constant), AUDIT, BOARD, DIVIDEND, EXCH, ASSETS, SUBSIDIA, AGE, ROA, PUBVSPRI

ANOVA(b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1529.806	13	117.677	3.916	.002(a)
	Residual	721.247	24	30.052		
	Total	2251.053	37			

a Predictors: (Constant), AINPLACE, EXCH, HISTORY, AUDIT, DIVERSIF, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA

b Dependent Variable: MANCG

Table 8.10
Coefficient Values and Associated Statistics for Model 5
(Nine Independent Variables)

	Unstandardised Coefficients		Standardised Coefficients	T Statistic	Significance.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	79.397	8.552		9.284	.000		
ASSETS	1.361	.726	0.373	1.876	.071	.545	1.835
PUBVSPRI	-6.876	3.242	-0.619	-2.121	.043	.253	3.949
BOARD	-9.797	7.253	-0.329	-1.351	.188	.363	2.752
EXCHANGE	-.381	1.043	-0.086	-0.366	.717	.390	2.562
DIVIDEND	2.433	4.815	0.096	0.505	.617	.592	1.690
SUBSIDIA	.259	.227	0.229	1.140	.264	.535	1.868
AGE	3.621E-02	.039	0.232	0.928	.361	.345	2.902
ROA	-292.999	126.4 0	-0.488	-2.318	.028	.487	2.055
AUDIT	2.442	2.523	0.212	0.968	.341	.448	2.232

a Dependent Variable: Mandatory Elements of Total Disclosure Index

Again the model performed with limited success explaining just over 20% of the variation of the mandatory elements of the total index of corporate governance disclosures. Again only two variables were statistically significant at less than 5%, namely profitability proxied by return on assets remaining significant (at 2.8%) and the ownership dummy (PUBVSPRI in Table 8.10) becoming significant (at 4%). Size retained significance at a lower level (7%). The significance of the profitability variable is consistent with previous studies (e.g. Cerf, 1961, Singhvi, 1967, Haniffa and Cooke, 2002), ownership is also consistent with the study of Haniffa and Cooke, (2002) and the result for the size variable is also supported by previous studies (Cooke 1989a, 1992; Ahmed and Nicholls, 1994; Hossain et al., 1994; Wallace et al.,

1994; Craig and Diga, 1998; Hossain, 2000; Hossain, 2001). No other variable was significant. The negative sign on the ownership dummy is contrary to the hypothesis that public sector banks would be more compliant with mandatory disclosure requirements due to state ownership involvement. I may suggest that public sector banks' compliance may be weaker due to bureaucratic inefficiencies in monitoring whilst private banks may be more willing to comply with regulations to signal probity in their behaviour. Consequently I may accept hypotheses one (with less confidence than for total corporate governance disclosures) and four and reject the other seven. I next report the application of model 4 to voluntary corporate governance disclosures.

8.4.3 Determinants of the Voluntary Elements of the Total Corporate Governance Disclosure Index (Nine Independent Variables)

The explanatory variables of Model 4 were applied with the dependent variable as the score based on the (11) voluntary elements in the total corporate governance disclosure index score for all banks and the resulting model was designated Model 6. The overall performance of this model is reported in Table 8.11 with Table 8.12 showing the coefficient values and associated statistics for Model 4.

Table 8.11
Overall Performance for Model 6 (Nine Independent Variables)

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.469(a)	0.220	0.031	12.1947	0.220	0.877

a Predictors: (Constant), AUDIT, BOARD, DIVIDEND, EXCH, ASSETS, SUBSIDIA, AGE, ROA, PUBVSPRI

ANOVA(b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2223.095	13	171.007	1.318	.270(a)
	Residual	3114.379	24	129.766		
	Total	5337.474	37			

a Predictors: (Constant), AINPLACE, EXCH, HISTORY, AUDIT, DIVERSIF, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA, b Dependent Variable: VOLCG

Table 8.12
Coefficient Values and Associated Statistics for Model 6
(Nine Independent Variables)

	Unstandardised Coefficients		Standardised Coefficients	T Statistic	Significance	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	.504	19.803		.025	.980		
ASSETS	2.885	1.750	.370	1.648	.110	.552	1.811
PUBVSPRI	5.130	7.581	.215	.677	.504	.275	3.630
BOARD	10.237	16.283	.161	.629	.535	.425	2.352
EXCH	-.694	2.551	-.073	-.272	.788	.385	2.600
DIVIDEND	1.669	11.654	.031	.143	.887	.596	1.678
SUBSIDIA	.075	.558	.031	.135	.894	.523	1.912
AGE	-.039	.092	-.117	-.424	.675	.366	2.735
ROA	-481.993	307.265	-.376	-1.569	.128	.486	2.059
AUDIT	.025	4.214	.001	.006	.995	.904	1.106

a Dependent Variable: Voluntary Elements of Total Disclosure Index

The performance of the model was very poor explaining only 3% of the variation of the voluntary disclosure dependent variable. No explanatory variable was significant below 10% and only size and profitability approached even that level of significance (at 11% and 13% respectively). The discussion of disclosure performance earlier in this chapter showed that levels of voluntary disclosure were very low and subject to only modest variation so these results are not unexpected.

As a result of the modest to poor performance of the nine variable Model 4 and its variants Models 5 and 6, the model contained in Equation 9.1 (see Chapter Seven and the discussion of model and variables) was applied to corporate governance disclosures to

seek better understanding of disclosure behaviour and the results are discussed in the following sections.

8.4.4 Determinants of the Total Corporate Governance Disclosure Index (13 Independent Variables)

The model described in Equation 7.1 was applied with dependent variables based on the corporate governance disclosure index score for all banks using the thirteen explanatory variables which were:

1. Age of bank (in years)
2. Size of bank (proxied by total assets).
3. Profitability of bank (proxied by Return on Assets [ROA]).
4. Operational history of bank (proxied by a dummy variable for presence or absence of diversification).
5. Degree of geographic diversification of bank (proxied by a dummy variable if the bank has branches sited in at least three areas/states plus any foreign branches; 0 if otherwise).
6. Complexity of business of bank (proxied by actual number of subsidiaries).
7. A market discipline variable (proxied by the ratio of non-performing assets to total assets).
8. A market discipline variable (proxied by the capital adequacy ratio [CAR] for each bank).
9. Multiple listing of bank (measured by actual number of listing with stock exchanges).
10. Assets-in-place of bank (proxied by the ratio of value of net fixed assets to book value of total assets).

11. Level of audit firm monitoring of bank (a dummy variable scoring 1 if the number of auditors is in excess of the statutory minimum number of auditors; 0 if otherwise).
12. Board composition of bank (measured by the ratio of non-executive independent directors to the total number of directors on the board)
13. Dividend policy of bank (proxied by dividend paid).

Using this model (designated Model 7) in place of Model 4 involves the dropping of the ownership variable (which performed contrary to expectation although was statistically significant) and the addition of variables for operational history of bank, degree of geographic diversification, two market discipline variables (proxied by the ratio of non-performing assets to total assets, and the CAR ratio), and the assets-in-place of bank variable. Thus, I utilise several hypotheses from Model 4 (retaining the same designations) and adapt others (with re-designation) from the analysis reported in Chapter Seven as follows:

- H14:** *The level of corporate governance disclosure is positively associated with bank size.*
- H16:** *Banks with a greater proportion of non-executive directors on the board will disclose more information on corporate governance and will be more compliant with mandatory disclosure requirements, and will tend to make more extensive voluntary disclosures than banks with a smaller number of non-executive directors on the board*
- H17:** *There is a positive association between profitability and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*
- H18:** *There is a positive association between bank age and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*
- H19:** *There is a positive association between structural complexity and the level of total corporate governance disclosure, and with the level of*

compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.

- H20:** *There is a negative association between dividend payments and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*
- H21:** *Banks that are listed on more exchanges than the minimum will make greater total corporate governance disclosures than banks listed on the minimum number of exchanges (and positively with numbers of listing) and will have a greater level of compliance with mandatory disclosure requirements, and will have higher levels of voluntary corporate governance disclosures*
- H22:** *Banks with more auditors than the minimum stipulated will make greater total corporate governance disclosures than banks with the minimum number of stipulated auditors (and positively with numbers of auditors) and will have a greater level of compliance with mandatory.*
- H23:** *The CAR ratio will be negatively associated with the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*
- H24:** *Banks with well-established operating histories will tend to have higher levels of total corporate governance disclosure, and greater levels of compliance with mandatory disclosure requirements, and greater levels of voluntary corporate governance disclosures than those with less established operating histories.*
- H25:** *Banks that actively expand their networks either at home and/or abroad will tend to have higher levels of total corporate governance disclosure, and greater levels of compliance with mandatory disclosure requirements, and greater levels of voluntary corporate governance disclosures than those which disclose more information than those that have not expanded their networks.*
- H26:** *The NPA ratio will be negatively associated with the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*
- H27:** *There is an association between the proportion of assets-in-place and the level of total corporate governance disclosure, and with the level of compliance with mandatory disclosure requirements, and with the level of voluntary corporate governance disclosures.*

The overall performance of Model 7 is reported in Table 8.13 with Table 8.14 showing the coefficient values and associated statistics for Model 5. The model explains 39% of the variation in the dependent variable with explanatory variables which are significant at conventional levels being size (assets), profitability (return on assets), the non-performing assets ratio, and CAR, with the latter three variables displaying negative signs. Thus, I accept hypotheses 14, 26, and 27 but not 17 due to the inappropriate arithmetic sign.

Table 8.13
Overall Performance for Model 7 (13 Independent Variables)

R	R Square	Adjusted R Square	Standard Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.775(a)	0.601	0.385	4.28618	0.601	2.781

Notes:

1 Predictors for the R statistics are : (Constant), AINPLACE, EXCH, HISTORY, DIVERSIF, AUDIT, CAR, BOD, NPA, DIVIDEND, LOGASSE, AGE, SUBSIDIA, ROA

2 Dependent Variable: Total Disclosure Index

ANOVA(b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	664.140	13	51.088	2.781	.015(a)
	Residual	440.913	24	18.371		
	Total	1105.053	37			

a Predictors: (Constant), AINPLACE, EXCH, HISTORY, AUDIT, DIVERSIF, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA

b Dependent Variable: OVERALLC

**Table 8.14 Coefficient Values and Associate Statistics for Model 7
(13 Independent Variables)**

Variable	Unstandardised Coefficients		Standardised Coefficients	T Statistics	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	64.172	7.306		8.783	.000		
LOGASSE	1.732	0.699	0.488	2.476	.021	0.427	2.340
AGE	0.029	0.032	0.194	0.923	.365	0.376	2.659
HISTORY	1.372	1.847	0.115	0.743	.465	0.689	1.452
DIVERSIF	2.558	1.975	0.232	1.295	.208	0.519	1.928
ROA	-536.054	168.454	-0.918	-3.182	.004	0.200	5.010
NPA	-106.133	48.903	-0.702	-2.170	.040	0.159	6.292
EXCH	0.842	1.013	0.195	0.831	.414	0.301	3.321
CAR	-2.061	0.628	-0.562	-3.281	.003	0.567	1.764
BOD	1.507	5.154	0.052	0.292	.773	0.524	1.907
DIVIDEND	1.025	4.708	0.042	0.218	.829	0.451	2.217
SUBSIDIA	-0.125	0.256	-0.113	-0.486	.631	0.306	3.265
AUDIT	2.075	1.502	0.190	1.381	.180	0.879	1.137
AINPLACE	-0.679	2.197	-0.055	-0.309	.760	0.522	1.917

Note: Dependent Variable: Total Score on Corporate Governance Disclosure Index

8.4.5 Determinants of the Mandatory Elements of the Total Corporate Governance Disclosure Index

The explanatory variables of Model 7 were next applied with the dependent variable as the score based on the (46) mandatory elements in the total corporate governance disclosure index score for all banks and the resulting model was designated Model 8. The overall performance of this Model 8 is reported in Table 8.14 with Table 8.15 showing the coefficient values and associated statistics for Model 8. Table 8.14 reports a substantial increase in the explanatory power of the model when applied to mandatory disclosures with an improved adjusted R-squared of 68%, with the same explanatory variables showing significant at conventional levels (i.e. size of bank, profitability, the non-performing assets ratio, and CAR). The arithmetic signs on the coefficients were as

in the model run on the total corporate governance index. Thus, again I accept hypotheses 14, 23, and 26 but not 18 due to the inappropriate arithmetic sign.

Table 8.15
Overall Performance for Model 8 (13 Independent Variables)

R	R Square	Adjusted R Square	Standard. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.908	0.824(a)	0.680	0.506	5.48197	0.680

Note: (a) Predictors: (Constant), ASINPLAC, EXCHANGE, HISTORY, AUDIT, DIVERSIT, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA

Table 8.16
Coefficient Values and Associated Statistics for Model 8 (13 Independent Variables)

	Unstandardised Coefficients	Std. Error	Standardised Coefficients	T Statistic	Significance	Collinearity Statistics	VIF
	B		Beta			Tolerance	
(Constant)	-3.466	9.345		-0.371	.714		
LOGASSE	3.144	0.895	0.621	3.514	.002	.427	2.340
AGE	0.068	0.041	0.312	1.658	.110	.376	2.659
HISTORY	1.799	2.363	0.106	0.761	.454	.689	1.452
DIVERSIF	5.339	2.526	0.339	2.113	.045	.519	1.928
ROA	-601.889	215.451	-0.722	-2.794	.010	.200	5.010
NPA	-231.779	62.546	-1.074	-3.706	.001	.159	6.292
EXCH	2.936	1.296	0.477	2.265	.033	.301	3.321
CAR	-1.959	.803	-0.374	-2.439	.023	.567	1.764
BOD	11.139	6.592	0.270	1.690	.104	.524	1.907
DIVIDEND	-0.209	6.021	-0.006	-0.035	.973	.451	2.217
SUBSIDIA	-0.875	0.328	-0.557	-2.667	.013	.306	3.265
AUDIT	0.210	1.921	0.013	0.109	.914	.879	1.137
AINPLACE	4.777	2.810	0.272	1.700	.102	.522	1.917

Note: (a) Dependent Variable: Disclosure index for mandatory corporate governance items.

8.4.6 Determinants of the Voluntary Elements of the Total Corporate Governance Disclosure Index

The explanatory variables of Model 5 were finally applied to the index based on the (11) voluntary elements in the total corporate governance disclosure index score for all banks (designated Model 9). The overall performance of the model is reported in Table 8.16 with Table 8.17 showing the coefficient values and associated statistics for Model 5.

Table 8.17
Overall Performance for Model 9 (13 Independent Variables)

R	R Square	Adjusted R Square	Standard. Error of the Estimate	Change Statistics	
				R Square Change	F Change
0.645(a)	0.417	0.100	11.39148	0.417	0.270

Note: (a) Predictors: (Constant), ASINPLAC, EXCHANGE, HISTORY, AUDIT, DIVERSIT, DIVIDEND, BOARD, CAR2, AGE, ROA, ASSETS, SUBSIDIA, NPA

Table 8.18
Coefficient Values and Associated Statistics for Model 9 (13 Independent Variables)

	Unstandardised Coefficients		Standardised Coefficients	T Statistic	Significance.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	7.331	19.418		0.378	.709		
LOGASSE	2.708	1.859	0.347	1.457	.158	.427	2.340
AGE	0.059	0.085	0.178	0.699	.492	.376	2.659
HISTORY	7.768	4.910	0.297	1.582	.127	.689	1.452
DIVERSIF	10.549	5.250	0.435	2.009	.056	.519	1.928
ROA	-809.014	447.705	-0.631	-1.807	.083	.200	5.010
NPA	-151.660	129.969	-0.456	-1.167	.255	.159	6.292
EXCH	0.846	2.693	0.089	0.314	.756	.301	3.321
CAR	-2.883	1.669	-0.358	-1.727	.097	.567	1.764
BOD	4.078	13.698	0.064	0.298	.768	.524	1.907
DIVIDEND	6.793	12.512	0.126	0.543	.592	.451	2.217
SUBSIDIA	-0.770	0.682	-0.318	-1.130	.270	.306	3.265
AUDIT	0.064	3.992	0.003	0.016	.987	.879	1.137
AINPLACE	0.130	5.840	0.005	0.022	.982	.522	1.917

Note: (a) Dependent Variable: Disclosure index for voluntary corporate governance items.

The performance of the model was greatly reduced with the adjusted R-squared falling to only 10% with only two of the five variables which were significant in previous model runs remaining significant at levels approximating conventional significance (profitability, at 8.6%, and CAR at 10%). One new variable became significant at a conventional level, degree of diversification (at 6%) and showed the hypothesised arithmetic sign. Thus, I have grounds to consider acceptance of the elements of hypothesis 23 (for CAR) and 25 (for diversification) which apply to voluntary disclosures but not 17 due to the inappropriate arithmetic sign.

8.5 Conclusion

This chapter has reported the results of an empirical analysis of the corporate governance disclosures of the sample Indian banks. The study has shown variations in disclosure patters between public sector banks and their private sector equivalents in relation to total corporate governance disclosures and the mandatory and voluntary elements of the disclosure index. Thus, for total corporate governance disclosures when the banks were divided into public and private sector sub-samples private sector banks on average scored marginally higher than public sector banks with the latter showing a lower dispersion both in terms of range of disclosure score and standard deviation. Performance by the individual sample banks on the mandatory component of the total disclosure index showed for all banks a range of scores is from lowest 33 (71.73% of the 46 items in the index) to highest 45 (97.83 %) with a mean score of 37.71 (81.83%). Dividing the banks into public and private sector sub-samples indicated that private sector banks scored marginally higher than public sector banks. The scores for public sector banks showed lower dispersion both in terms of range and standard deviation. As with the total disclosure index presented in Chapter seven these results are in line with an expectation that mandatory levels of corporate governance disclosure will

be high but the levels of mean score for the mandatory items being well below 100% raises questions about compliance and enforcement. Interestingly, mean compliance levels for mandatory corporate governance disclosures were found to be below those for the total disclosure index items for all banks, with public sector banks performing worse than private. I conclude that levels of compliance are poorer and monitoring are weaker for mandatory corporate governance disclosures than for mandatory elements of total disclosure and that this is especially marked for public sector institutions. Performance by the individual sample banks on the voluntary components of the total corporate governance disclosure index showed a range of scores of one (1) (9.09%) to highest six (54.54%) with a mean score of 3.05 (27.75%). The standard deviation of absolute scores across all banks was 1.33 (of percentage scores 12.13). Private sector banks on average scored lower, thus reversing the relative positions for mandatory disclosures of corporate governance items, interestingly with the same relative performances as for the total disclosure index. The scores for public sector banks exhibited marginally smaller degrees of dispersion in range and standard deviation. I conclude that the results for voluntary disclosure are mixed in relation to expectations. Overall levels of disclosure are relatively low with only the best disclosers reaching at least 50% of the index. Private banks on average make less voluntary disclosure than public sector banks with a greater standard deviation of the scores. As expected, mean levels of voluntary disclosure are significantly below those of mandatory disclosure for all banks together and for both sub-samples.

I applied two regression models to the explanation of these variations, one involving nine variables (Model 4, with 5 and 6) and one thirteen variables (Model 7, with 8 and 9) with some variation of explanatory variables across the two. Model 4 performed modestly when applied to the total corporate governance index, with the independent

variables explaining only 20% of the variation and only two variables were statistically significant at acceptable levels (size and). No other variable was significant at better than level than 10%. When Model 4 was applied to the mandatory elements of the index (as Model 5) again the model performed with limited success explaining just over 20% of the with only two variables being statistically significant at less than 5%, namely profitability and the ownership dummy. Size retained significance at a lower level. The negative sign on the ownership dummy was contrary to hypothesis and it is suggested that public sector banks' compliance may be weaker due to bureaucratic inefficiencies in monitoring whilst private banks may be more willing to comply with regulations to signal probity in their behaviour. The performance of Model 6 was very poor in explaining variation in voluntary disclosure, explaining only 3%. No explanatory variable was significant below 10% and only size and profitability approached that level of significance. The data on disclosure performance presented this chapter showed that levels of voluntary disclosure were very low and subject to only modest variation making these results are not unexpected. An extended model (Model 7) was applied, dropping one variable (the ownership dummy and introducing five others), and the model explained 39% of the variation in total corporate governance disclosure with size (assets), profitability (return on assets), the non-performing assets ratio, and CAR, being significant with the latter three variables displaying negative signs. When Model 8 was applied to the (46) mandatory elements in the total corporate governance disclosure index overall performance showed a substantial increase in explanatory power with an adjusted R-squared of 68%. The same explanatory variables showed significance at conventional levels (i.e. size, profitability, the non-performing assets ratio, and CAR). The arithmetic signs on the coefficients were as in the model run on the total corporate governance index. Finally, when Model 9 was applied to voluntary disclosures performance was

greatly reduced with the adjusted R-squared falling to 10% with only two variables remaining significant at levels approximating conventional significance (profitability, at 8.6%, and CAR at 10%) and one new variable becoming significant, degree of diversification (at 6% and showing the hypothesised arithmetic sign).

CHAPTER NINE

SUMMARY, CONCLUSIONS, LIMITATIONS AND RECOMMENDATIONS FOR POLICY AND FURTHER RESEARCH

9.1 Introduction

This chapter provides an overall conclusion to the study and offers recommendations and suggestions for policy and for further research. The chapter is organised as follows. Section 9.2 provides a brief summary of the thesis and the research while Section 9.3 provides a review of the main conclusions of the research. Section 9.4 notes some of the contributions and limitations of the research while finally Section 9.5 presents the author's recommendations for policy in relation to disclosures by banks, in particular in the Indian context, and also for further research which might be undertaken into this subject. Section 9.6 provides brief closing remarks.

9.2 Summary of the Thesis and the Research

The ten substantive chapters above, together with the Preface provide a detailed examination of the disclosure practices of a sample of Indian banks containing both private sector banks and public sector banks. Chapter One describes the roles and importance of financial systems, especially in developing countries like India, and explains how the financial system affects economic growth. A discussion of aspects of the Indian financial system is provide indicating that India is characterised by a large network of both foreign and domestic banks, a well-developed stock market, and financial

institutions. The chapter also sets out the rationale for the research as well as its main objectives which are reproduced below:

- i. To describe the nature and structure of the financial sector in India;
- ii. To analyse the regulatory and financial environment of the Indian banking sector both in relation to banks and other financial institutions *per se* and to corporate disclosures by banks and to place regulation in its broader, external context;
- iii. To highlight the stages of development of the banking sector and its impact on the economy;
- iv. To elaborate a literature review in relation to banking disclosure and transparency;
- v. To establish hypotheses in order to assess the corporate attributes which explain the variation in the extent and quality of overall financial reporting of Indian banking companies and of corporate governance items;
- vi. To collect data on Indian banks' overall disclosures of financial information and of corporate governance items and to assess levels of disclosure and the causes of variation in disclosure levels between banks against those hypotheses;
- vii. To analyse the results of the study's hypothesis testing and to draw conclusions, and recommendations and policy implications based on findings of the research.

Objectives (i) and (ii) are addressed in Chapter Two, which reviews the institutional framework and regulatory environment for the Indian financial sector: banks and stock markets; in Chapter Three, objectives (iii) which reviews the banking sector

reform in India and external regulatory influences on Indian banks. Objective (iv) is considered in Chapter Four which provides a review of the academic and practitioner literature related to disclosure index studies. Chapter Five contains the theoretical framework of the study and discussion of research methodology and in particular issues of sample selection and collection of annual reports, selection of items of information included in the disclosure index including the mandatory and voluntary items of information, the scoring of the disclosure index, the specification of the dependent and independent variables used in the statistical analyses in the study, and sets out the general form of regression model utilised. This discussion provides the basis for the addressing of research objective (v). Chapter Six, together with a further discussion in Chapter Eight, establishes hypotheses in order to assess the corporate attributes which explain the variation in the extent and quality of overall financial reporting of Indian banking companies and of corporate governance items, thereby addressing research objective (v). Chapter Seven provides the empirical analysis of general bank disclosures both in relation to levels and variations in disclosure and in relation to firm-specific determinants and made a comparison between Indian accounting standards and IAS. Chapter Eight provides the equivalent analysis for corporate governance disclosures thereby addressing aspects of research objective (vi and vii). These latter two chapters represent the empirical core of the research and the main focus of the research. Thus, the main purpose of the research reported in the thesis is to examine empirically overall performance in general disclosures and disclosures on corporate governance of the sample and the two sub-samples (for public and private sector banks), variations in disclosures between banks and sub-samples, and associations between a number of corporate attributes and levels of disclosure in corporate annual reports in order to analyse the quality of financial reporting by Indian banks. Disclosure is measured using disclosure indices based on a dichotomous model. Most of the previous research in this

area has concentrated on non-financial companies in both developed and developing countries, with the result that research on financial companies, and especially banking companies, is limited. India is the largest country in South Asia with a huge financial system and banks that were established according to the British pattern. Recent financial stress in East Asian economies, has urged the World Bank, and IMF to promote financial stability and greater disclosure and transparency in banking companies. Within this framework the study considered 38 banks listed on the stock exchanges in India. A total of 184 items of information comprising both mandatory (101) and voluntary (81) items was selected for the general disclosure index, and a linear regression model was been developed in order to examine the relationship between various corporate attributes and the level of disclosure. Separate studies were undertaken of the determinants of total disclosures and of the mandatory and voluntary items comprising the total index. The corporate governance items were extracted for the total disclosure index and enhanced by the inclusion of additional items to create a corporate governance index of 57 items comprising 11 voluntary and 46 mandatory items. Two linear regression models, one with nine explanatory variables the other with thirteen, were applied in the attempt to explain variations in corporate governance disclosures and in each case to the total corporate governance index and then to the voluntary and the mandatory items indices separately.

9.3 Review of Main Conclusions of the Research

Chapter Two concluded that India has a mature structure for its banking sector and a developing and strong capital market with sound and efficient institutional and regulatory environment with strong supervision and monitoring networks. Chapter The chapter also concluded that the disclosure of information in bank annual reports is closely guided by the RBI and SEBI. New norms of RBI and Clause 49 of SEBI

have introduced a new dimension in the Indian banking sector and have been provided signals to reach a high standard of transparency and disclosure. Chapter Three concluded that the financial reforms which commenced in 1991 have produced significant favourable, changes in India's highly regulated banking sector. In documenting the reform process and its consequences the chapter noted that a distinguishing feature of the reform process in India has been its 'gradualism', which was the outcome of India's democratic and highly pluralistic political system in which reforms could be implemented only if based on popular consensus. It was noted that since 1969 India has reformed its practices in almost every aspect, including disclosure and transparency and corporate governance, all of which have been treated with high priority by policy-makers. Transparency and disclosure standards recommended in International Accounting Standards have been implemented in a phased manner. With effect from 31 March 2000 Indian banks have been advised to disclose their maturity pattern of deposits, borrowings, investments and advances and foreign currency assets and liabilities, movements in Non-Performing Loans Assets and lending to sensitive sectors and from year ended 31 March 2001, banks were advised to disclose total advances against shares and total investments made in equity shares, convertible debentures and equity-oriented mutual funds. Further, from 31 March 2002, banks have been required to disclose movement of provisions held towards NPAs and movement of provisions held towards depreciation of investments, the total amount of standard/ sub-standard assets subjected to CDR as well as in other areas. In addition, this chapter concluded that external regulatory influences have an influence on Indian banking and certain of these bodies and their recommendations or rules are used in the determination of the items to be analysed as part of voluntary disclosures in the empirical sections of this thesis. Chapter Four reviewed studies of corporate disclosure by academics undertaken since the effective start of systematic study of disclosure using disclosure

indices in 1961. The chapter noted that research has examined disclosures in a wide range of countries and numerous studies have been directed at non-financial companies. It also noted that very limited systematic attention has been directed at banking or other financial companies by academics using disclosure indices or similar methodology and that, significantly for the research reported in this thesis, only one substantive academic study appears to be available for banking companies in India. The review of non-academic bodies, regulatory and commercial with interests in banking, provided some helpful insights into practitioners' views and banks' practices in disclosure. However, it was noted that those studies either focused on particular aspects of banks disclosures such as risk or were part of more general interests such as corporate governance whereas academic studies were much more likely to be focused on financial reporting alone. The literature review provided a basis for applying the methodology of disclosure indices to relatively under-researched Indian banking companies. It is noted that studies had used disclosure indices composed of voluntary information items alone, mandatory items alone, and voluntary and mandatory items together and that a range of corporate attributes had been used to explain variations and levels of disclosure. The chapter concluded that corporate attributes may be divided into three broad categories of corporate characteristics that can affect the degree of corporate disclosure namely, financial characteristics of the firm; the firm's corporate governance characteristics; and market discipline variables. Based on this it was concluded that the present study would propose financial variables; corporate governance variables, and market discipline variables as possible determinants of the degree of corporate disclosure and transparency within the Indian banking market. Chapters Five and Six were devoted to developing the methodology and hypotheses of the study.

Chapter Seven provided empirical results on the levels of disclosure achieved by individual banks on the total disclosure index and its mandatory and voluntary components. These results showed variations between public and private sector banks for the three forms of the disclosure index. Of particular importance was the evidence of a mean disclosure deficiency in the mandatory items of approximately 10 percentage points (with variations between public and private banks) from the maximum mandated disclosures. Combining this with the results of the regression analysis presented later in the same chapter I suggested that this might be explained by weak regulatory supervision or poor internal compliance or control of compliance. The presence of statistically significant variables of expected signs (both positive) on size and board composition supported this interpretation if size was taken to be associated with political visibility and political costs of non-compliance with mandated disclosures and if active and dominant non-executive directors protected reputational capital by trying to enforce regulatory compliance. Chapter Seven also presented regression analyses applied to the total disclosure index and its mandatory and voluntary components. This produced strong adjusted R squared for model 1 (total disclosure) and Model 3 (voluntary disclosure) but relatively poor explanatory performance for mandatory disclosure (Model 2). Detailed reviews of the hypotheses were provided in relation to Model 1 and other comments were made on results for Models 2 and 3. For Model 2 coefficients representing bank size reduced in significance from its value in Model 1 and the market discipline variable NPA became insignificant whilst CAR remained statistically significant and again had a negative sign. Of other variables only profitability (again with contrary sign) and board composition were statistically significant at a conventionally levels. As noted above since the dependent variable in Model 2 was based on mandatory items our general expectation was that all banks would adhere strictly to the disclosure of such items. The negative sign on profitability was again not as predicted and could be consistent with a

defensive approach by unprofitable banks through increased disclosure. Model 3 produced an adjusted R squared of 0.504 indicating the best explanatory performance of the three models tested in Chapter Nine. For Model 3 independent variables which were statistically significant were size (at 1%), geographic diversification (5%), profitability (1%), market discipline NPS version (1%), market discipline CAR (2%), multiple stock exchange listing (at 3%), composition of board of directors (at 10%), complexity of business (at 1%), and assets-in-place (at 10%). The sign for size was positive as expected, as were those for geographic diversification, multiple stock exchange listing, composition of board, and assets-in-place, indicating acceptance of the associated. Of the other statistically significant variables signs contrary to expectation were obtained for the variables on profitability (as with Models 1 and 2), the two market discipline variables, and complexity of business indicating that the associated hypotheses could not be accepted.

Finally, Chapter Eight reported results of empirical analysis of the corporate governance disclosures of the sample banks. The study showed variations in disclosure patterns between public sector and private sector banks in relation to total corporate governance disclosures and the mandatory and voluntary elements of the index. Thus, for total corporate governance disclosures private sector banks on average scored marginally higher than public sector banks with the latter showing lower dispersion by range of disclosure score and standard deviation. Performance by the individual sample banks on the mandatory component showed for all banks a range of scores from lowest 33 (71.73% of items) to highest 45 (97.83 %) with a mean score of 37.71 (81.83%). Private sector banks scored marginally higher than public sector banks. The scores for public sector banks showed lower dispersion both in terms of range and standard deviation. As with the total disclosure index presented in Chapter Nine these

results were in line with an expectation that mandatory levels of corporate governance disclosure would be high but the levels of mean score for the mandatory items were well below 100% raising questions on compliance and enforcement. Interestingly, mean compliance levels for mandatory corporate governance disclosures were below those for the total disclosure index for all banks, with public sector banks performing worse than private. I concluded that levels of compliance were poorer and monitoring weaker for mandatory corporate governance disclosures than for mandatory total disclosure and that this was more marked for public sector banks. Performance by the individual sample banks on the voluntary components of corporate governance disclosure showed a range of scores of one (1) (9.09%) to six (54.54%) with a mean score of 3.05 (27.75%). The standard deviation of absolute scores across all banks was 1.33 (of percentage scores 12.13). Private sector banks on average scored lower, reversing the relative positions for mandatory corporate governance items, with the same relative performances as for the total disclosure index. The scores for public sector banks exhibited marginally smaller dispersion in range and standard deviation. I concluded that the results for voluntary disclosure were mixed in relation to expectations. Overall levels of disclosure were relatively low with only the best disclosers reaching at least 50% of the index. Private banks on average made less voluntary disclosures than public sector banks and with greater standard deviation of scores. As expected, mean levels of voluntary disclosure were significantly below those of mandatory disclosure for all banks and for both sub-samples.

Two basic regression models were applied to the explanation of these variations, one involving nine variables (Model 4, with 5 and 6) and one of thirteen variables (Model 7, with 8 and 9) with some variation of explanatory variables across the two. Model 4 performed modestly when applied to the total corporate governance index, with

independent variables explaining only 20% of variation and only two variables being statistically significant at acceptable levels (size and profitability). No other variable was significant at better than level than 10%. When Model 5 was applied to the mandatory elements of the index again the model performed with limited success explaining just over 20% of the with only two variables being statistically significant at less than 5%, namely profitability and the ownership dummy. Size retained significance at a lower level. The negative sign on the ownership dummy was contrary to hypothesis and it was suggested that public sector banks' compliance might be weaker due to bureaucratic inefficiencies in monitoring while private banks might be more willing to comply with regulations to signal probity in their behaviour. The performance of Model 6 was very poor in explaining variation in voluntary disclosure, explaining only 3%. No explanatory variable was significant below 10% and only size and profitability approached that level of significance. The data on disclosure performance presented in Chapter Ten showed that levels of voluntary disclosure were very low and subject to only modest variation making these results not unexpected. An extended model (Model 7) was applied, dropping one variable (ownership dummy and introducing five others), and the model explained 39% of the variation in total corporate governance disclosure with size (assets), profitability (return on assets), the non-performing assets ratio, and CAR, were significant with the latter three variables displaying negative signs. When Model 8 was applied to the 46 mandatory elements overall performance substantially increased in explanatory power with an adjusted R-squared of 68%. The same explanatory variables showed significance at conventional levels (i.e. size, profitability, the non-performing assets ratio, and CAR). The arithmetic signs on the coefficients were as in the model run on the total corporate governance index. Finally, when Model 9 was applied to voluntary disclosures performance was greatly reduced with the adjusted R-squared falling to 10% with only two variables

remaining significant at levels approximating conventional significance (profitability, at 8.6%, and CAR at 10%) and one new variable becoming significant (degree of diversification at 6% and showing the hypothesised arithmetic sign).

9.4 Contributions and Limitations of the Research

The major contributions of the study are as follows:

- i. It is a comprehensive study aiming to understand the disclosure behaviour (total, corporate governance, mandatory and voluntary) of banking companies in India.
- ii. It is only the second study of such companies and one of very few on financial companies in developing countries.
- iii. The selection of items for inclusion in the various versions of the disclosure index has been made on the basis of Indian national rules, and regulations, and international bodies' recommendations, and literature relating to banking companies.
- iv. The study has included a number of new corporate attributes that might impact on the level of disclosure.
- v. The study has provided insights into how Indian banks conduct their financial reporting practices in general, and in relation to corporate governance.
- vi. The study provides insights into regulations and regulatory behaviour in India in relation to banks and their reporting practices.

A number of limitations may be noted:

- i. Sample size, whilst adequate for the research which is reported could usefully be extended.

- ii. The use of a dichotomous disclosure index does not capture the influence of preferences of groups of users on the relative important of various items of information in order to capture other dimensions of the value of disclosures made or the value lost by non-disclosure.
- iii. Certain variables, e.g. dividends, profitability, audit monitoring, complexity and others, are subject to alternative specifications which might produce improved explanatory power for variations in disclosure levels.
- iv. The two sub-samples were not analysed separately in relation to the explanatory variables to determine whether public or private sectors behaved differently in terms of the explanations of disclosure level variations.
- v. Only one year was studied and this may mask variations through time or the influence of particular events around the study year.
- vi. The statistically significant variables from the nine and thirteen variable models were not combined to produce further models to give additional explorations of the variations in disclosure levels.
- vii. Data for only one country was used so no cross-country comparisons are available.

9.5 Recommendations and Directions for Future Research

The main recommendations are as follows:

For Policy

As a result of the reform process and monitoring structures of the RBI, India has apparently reached a significant of transparency, corporate governance, and a high level of disclosure by its banks. More specifically, the reforms have been argued to have been successful in bringing significant improvements in various financial market

segments, improving their depth, liquidity and efficiency. Financial markets are now considered reasonably developed with a wide array of instruments and reforms have also been considered to be successful in creating and sustaining orderly conditions in the markets. These factors have led to increased inter-linkages across financial institutions and markets. In the more recent period, the various segments of the financial market in India have, by and large, exhibited stability. Rajan and Zingales, (2000, p 20) stated that “to function properly a financial system requires clear laws and rapid enforcement, an accounting and disclosure system that promotes transparency and a regulatory infrastructure that protects consumers and controls risk”. It is also well understand that transparent accounting and corporate disclosure may reduce information asymmetry and pre-requisite consumption by improving contracting and monitoring. Policy makers and regulators of Indian banking might usefully consider the evidence presented in this thesis on the levels and variations in disclosure of overall items and corporate governance and in particular consider the implications of less than 100% disclosure of mandatory items. This, together with the differences in disclosure behaviour by individual banks and across broad sectors, suggests significant variation in disclosures which may indicate that reform has produced nominal improvements in some aspects but with some real disclosure problems remaining. The nature and focus of the present research concludes that in order to maintain high quality disclosure and transparency as well as build up investors and depositors’ confidence, it is imperative to comply with the rules and regulations of the regulatory authorities. In addition, the guidelines and recommendations issued by international organisations such as the World Bank, IMF, BASEL, and IASB should be followed and enforced in order for Indian banks to reach international standards of disclosure. The Indian banking sector is nominally

very closely monitored by regulators, but levels of disclosure, especially mandatory, do not entirely reflect this, showing variations around generally good levels (sometimes high) levels of compliance. Voluntary disclosure is not high and for corporate governance items is very low so at present it is not clear that market incentives cannot be relied on to drive voluntary disclosure ahead of regulation. Perhaps understandably, sample banks appeared reluctant to disclose information voluntarily (perhaps because it was considered to be politically or socially sensitive. These results are generally consistent with the findings of Teoh and Thong (1984), and point to corporate financial reporting in the ASEAN region being oriented strongly towards the information needs of capital providers and regulators, rather than the needs of a broader set of stakeholders (including employees, government agencies and the general community). Regulators may wish to consider this in their development of new regulations and the balance which they adopt between mandatory and voluntary disclosures. Ideally, increased transparency through the disclosure of timely and accurate information should enable a bank to access capital markets more efficiently. Market discipline based on information should contribute to the efficient allocation of capital and provide incentives for banks to operate efficiently and to manage and control their risk exposures prudently. In particular, increased transparency should reduce the magnitude and frequency of bank problems insofar as enhanced disclosure allows market participants to impose market discipline earlier and more effectively.

For Academic Research

A number of directions may be suggested for future academic research on the topic. Thus:

- i. Sample size could usefully be extended.

ii. The use of a weighted disclosure index can enhance understanding by capturing the influence of preferences of groups of users on the relative importance of various items of information. This would require interview and survey research of user groups to determine preference weightings.

ii. Certain variables, e.g. dividends, profitability, audit monitoring, complexity and others, could be presented in alternative specifications in order to test whether they give improved explanatory power for variations in disclosure levels.

iii. The two sub-samples could perhaps usefully be analysed separately in relation to the explanatory variables to determine whether public or private sectors behaved differently in terms of the explanations of disclosure level variations.

vi. Additional years could be studied to identify variations through time or the influence of particular events around the study years.

vii. The statistically significant variables from the nine and thirteen variable models could be combined to produce further models to give additional explorations of the variations in disclosure levels.

viii. Data for other comparable countries could be generated to provide the basis for cross-country comparisons of disclosure levels and variations and the influence of explanatory variables. The work undertaken in India could be replicated in other South East Asian countries, in order to develop a comprehensive understanding of the reporting practices of the banks in the region. In addition, exploratory variables could be introduced to capture country differences, thus further widening overall understanding of the ASEAN region, allowing international financial institutions and academics better to understand the disclosure activities of banks in the region.

9.6 Closing Remarks

India is a rapidly developing country which has a strong capital market and financial institutions and also has other specific characteristics which make it distinctive. For example, India is the largest multi-party democracy in the world; it has a well established independent judicial system; and in terms of education in the field of literature, computer engineering and programming, science and technology and business management and administration, is considered to meet the highest global standards. These characteristics, amongst others, have contributed to its recent dramatic economic growth and emergence, with China in particular, as a major Asian driven of the world economy. The country's financial reporting system derives from a UK model as is the case in many former British colonies and is relatively well-developed and increasingly internationalised. The thesis has provided evidence from theoretical and empirical studies that the quality of financial systems and the quality of financial reporting are likely to be drivers of economic development and growth. Due to the convergence of all of these issues in India, any research work undertaken in this country on financial reporting of financial institutions has the potential to provide insights which are empirically and theoretically useful. The nature of the present study has been to seek to evaluate the financial reporting practices of banks in India and, it is hoped, the findings are both of interest and value in themselves and also suggest directions on improvements in practice and compliance with both general financial disclosures and those on corporate governance in particular. If improvements in disclosure occur, whether by market forces or the actions of the Indian regulatory authorities this may help to build further confidence of investors in the Indian economy and provide guidance for other developing countries considering their individual country circumstances.

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Appendix 1

Major Reforms in the Banking Sector in India, 1992-2002

The major steps taken in reforming the banking system can be summarised under five sub-headings.

1. Liberalising Controls over Commercial Banks

- Reduction in the range of control over interest rates paid by banks on deposits. However, the interest rate on savings deposits is still fixed by the RBI and interest on 30-day deposits is limited to the bank rate.

- Dismantling of the extensive control exercised earlier on interest rates on various types of loans, depending on size of loan and sector. The only controls on lending rates at present are:

- Retention of very low interest rates on loans under the Differential Rate of Interest scheme. However, these loans account for a very small proportion of total loans.

- Interest rates on export credit, where the RBI provides refinance, are at controlled rates.

- Abolition of the credit authorisation scheme under which credit limits of large borrowers required the approval of the RBI.

- Reduction in cash reserve requirements (CRR) and the statutory liquidity ratio (SLR), which earlier pre-empted a large proportion of the resources of commercial banks.

2. Prudential Norms and Standards

- Stipulation of a minimum capital to risk assets ratio, which was first fixed at 8% and was later raised to 9%.

- Norms for income recognition, asset classification, and provisioning were introduced and have been progressively tightened, though they are still to reach international levels.

- Prescription of enhanced disclosure requirements on the maturity pattern of deposits, borrowings, investments, loans and advances, movements in non-performing assets (NPAs), and lending to market-sensitive sectors such as for

example, real estate, commodities, and the capital market.

3. Strengthening Supervision

- Supplementing traditional on-site supervision by a system of off-site supervision based on a regular flow of information from the banks, which will allow a closer and more continuous monitoring of asset quality, capital adequacy, large exposures, connected lending, etc.
- Prescription of prudential exposure limits for individual borrowers and for inter-connected groups of borrowers in terms of percentages of capital of the bank.
- Prescription of norms for valuing government securities by marking to market.
- Prescription of enhanced disclosure requirements on the maturity pattern of deposits, borrowings, investments, loans and advances, movements in non-performing assets (NPAs), and lending to market-sensitive sectors such as for example, real estate, commodities, and the capital market.
- Adoption of a CAMEL (capital adequacy, asset and management quality, earnings, and liquidity and systems of risk management) approach to assessing the financial position of a bank in on-site supervision.
- Strengthening of the role of external auditors.

4. Encouraging Competition

- Issue of new licenses to Indian private-sector banks, subject to restrictions on control of the banks by industrial houses.
- More liberal licensing of foreign bank branches.

Dilution of government ownership of the public-sector banks by allowing private equity to be inducted, subject to the government retaining a majority share. A proposal to amend the laws to allow the government equity to be reduced to 33.33% has been submitted to the Parliament, but has yet to be enacted.

- Foreign banks have been permitted to have up to 74% equity in Indian private-sector banks.

5. Legal Framework

- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002, which enables banks to foreclose on collateral in the case of defaulting borrowers without cumbersome legal procedures.

Companies Amendment Act of 2002, which establishes a National Tribunal to which companies in default on payments due for 270 days can be referred, triggering a process by which they must either present a structuring plan acceptable to creditors, or suffer liquidation.

Source: Ahluwalia, 2002, "Financial Sector Reforms in India: An Assessment" paper presented at conference on Financial Sector Reform Across Asia: Facts, Analyses, Solutions, John F. Kennedy School of Government, Harvard University, December.

Appendix 2

Major Events in the Recent History of the Indian Banking Sector

Date	Event
1969	Nationalisation of Private banks (1 st round)
1973	Foreign Exchange Regulation Act ERA
1979	Priority Sector Lending Requirement of 33% (effective date)
1980	Nationalisation of Private Banks (2 nd round)
1985	Priority Sector Lending Requirement Raised to 40% (effective date)
1991	(Narasimham) <i>Report of the Committee on Financial System</i> , outlining reform strategy
1992/93	Financial liberalisation begins with the beginning of gradual liberalisation of interest rates, easing of CRR and SLR, beginning of recapitalisation of public sector banks, gradual introduction of 8% capital norms (on risk weighted assets), tightening of income recognition and provisioning norms, and easing of controls of offshore financing of corporations
1993	Recovery of debts due to Banks and Financial Institutions Act, creating Debt Tribunals
1993	Board of Financial Supervision and Department of Supervision set up in the Reserve Bank of India
1993	State Bank becomes first public sector bank to issue shares in the capital market (33% of equity)
1993/94	Six new private banks commenced operation with four more in the next fiscal ; entry limitations on foreign banks eased,

	resulting in increase of foreign banks
1998	(Narasimham) <i>Report of the Committee on Financial System</i> , outlining second round reform strategy
2000	Foreign Exchange Management act (replaced FERA), eased capital controls

Source: various sources: Joshi and Little, 1996; Kumbhakar and Sarkar, 2003; Jaffry et al. 2007.

Appendix 3
Select Chronology of Developments in the Indian Financial Sector

Year	Event
1770	Bank of Hindustan, the first modern-form bank established.
1875	Bombay Stock Exchange started formal trading.
1918	Oriental Life Insurance Company established.
1850	First general insurance company established.
1921	Three Presidency banks, Bank of Bengal, Bank of Madras, and Bank of Bombay, merged into Imperial Bank.
1926	Establishment of Hilton-Young Commission to suggest a central bank for the country.
1935	Establishment of Reserve Bank of India as the Central Bank.
1947	Capital Issues Control Act imposed restrictions on issue of capital.
1948	Establishment of Industrial Finance Corporation, the first DFI.
1955	Imperial Bank taken over by State Bank of India: Establishment of Industrial Credit and Investment Corporation of India.
1956	Life Insurance Company of India came into effect.
1962	Deposit Insurance Corporation established.
1963	Insertion of a new Chapter in RBI Act, 1934 to effectively supervise, control and regulate deposit-taking activities of NBFCs.
1964	Establishment of Industrial Development Bank of India.
1966	Deposit insurance extended to co-operative banks.
1969	Nationalisation of 14 largest commercial banks.
1973	Nationalisation of general insurance companies.
1975	Establishment of Regional Rural Banks.
1980	Second round of nationalisation of six commercial banks.
1982	Establishment of National Bank for Agriculture and Rural Development; First Credit Rating Agency established in India.
1990	Establishment of Small Industries Development Bank of India.
1991	Report of the Committee on the Financial System, which provided the blueprint for first generation financial sector reforms.

1992	Introduction of prudential norms for income recognition and asset classification; SEBI obtained statutory powers to promote orderly development of capital market; Incorporation of National Stock Exchange (NSE) as the first screen-based and transparent trading platform for investors; Introduction of auction system for Government securities.
1993	Introduction of depositories.
1994	Board for Financial Supervision, an autonomous body under the aegis of RBI, established; New guidelines for entry of new private sector banks announced; Wholesale debt market operations initiated by NSE.
1996	Establishment of Institute for Development and Research in Banking Technology; Depositories Act was passed which allowed for holding of securities in dematerialised form.
1997	Promulgation of RBI (Amendment) Act for intensified regulation of deposit-taking NBFCs; Termination of automatic monetisation of Government deficit; Bank Rate activated as a signalling rate; Statutory Liquidity Ratio (SLR) reduced to 38.5% (legal minimum).
1999	Insurance Regulation and Development Act passed allowing new players/joint ventures to undertake insurance business; Detailed guidelines on risk management in banks announced; Standing Committee on International Financial Standards and Codes set up to evolve sound standards based on recognised best practices.
2000	Guidelines issued regarding interest rate swaps and forward rate agreement to enable financial entities to hedge interest rate risk; New guidelines for categorisation and valuation of banks' investment portfolio announced; Liquidity adjustment facility introduced; Foreign Exchange Management Act, replacing the earlier FERA, introduced.
2001	Establishment of Credit Information Bureau of India Ltd.
2002	Revised guidelines announced for entry of new private banks; Enactment of SARFAESI Act for enforcement of security interest for secured creditors; Establishment of first universal bank in the country; Clearing Corporation of India Limited became operational; consolidated guidelines issued on FDI in banking.
2003	Central Listing Authority was constituted.

Source: Joshi and Little, 1996; Deolalkar, 2000; Kumbhakar and Sarkar, 2003; Jaffry et al. 2007.

Appendix 4

Voluntary and Mandatory Items; Breakdown by Major Category

<u>A. Voluntary items:</u>	
A. Background about the Bank/General Corporate Information	06
B. Corporate Strategy	03
C. Corporate Governance	11
D. Financial Performance	13
E. General-risk Management	07
F. Credit Risk Exposure	08
G. Market Risk Exposure:	04
H. Interest Rate Risk:	03
I. Currency Risk:	03
J. Liquidity Risk Exposure:	03
K. Accounting Policy Review	02
L. Key Non-financial Statistics	08
M. Corporate Social Disclosure:	04
N. Others	08
Total	83
<u>B. Mandatory items:</u>	
A. Balance Sheet Items	13
B. Profit and Loss Account Items	07
C. Board of Director's Report	05
D. Corporate Governance	44
E. Management Discussion and Analysis	08
F. RBI Guidelines	24
Total	101
Grand Total (A+B)	184

Appendix 5

List of Voluntary Items in Total Disclosure Index

No.	Items of Information
A	Background about the bank/general corporate information (06):
1	Brief narrative history of the Bank
2	Basic organisation structure/chart/description of corporate structure
3	General description of business activities
4	Date of establishment
5	Official address/registered address/address for correspondence
6	Web address of the bank/email address
B	Corporate Strategy (03):
7	Management's objectives and strategies/corporate vision/motto/statement of corporate goals or objectives
8	Future strategy - Information of future expansion (capital expenditures)/general development of business
9	Impact of strategy on future results
C	Corporate Governance (11):
10	Detail about the chairman (other than name/title) background of the chairman/academic/professional/business experiences
11	Details about directors (other than name/title) background of the directors/academic/professional/business experiences
12	Number of shares held by directors
13	List of senior managers (not on the board of directors)/senior management structure
14	Background of senior managers
15	Details of CEO's contact address
16	Specification of the independent directors and definition of roles
17	Details of chairman of the board of directors

18	Directors' engagement/directorship of other companies
19	Picture of all directors/board of directors
20	Picture of chairperson only
D	Financial Performance (13):
21	Brief discussion and analysis of a bank's financial position
22	Discussion of the bank's liquidity position and additional financing
23	Qualitative forecast of earnings
24	Return on equity
25	Net interest margin
26	Cost-to-income ratio
27	Earning per share
28	Risk-weighted assets
29	Debt-to-equity ratio
30	Total liquid assets to assets ratio
31	Total liquid assets to deposit ratio
32	Loan to deposit ratio
33	Dividend per share
E	General Risk Management (07):
34	Discussion of overall risk management philosophy and policy
35	Narrative discussions on risk assets, risk measurement and monitoring
36	Discussion on risks rise, how risks are managed and controlled
37	Whether and how hedges and derivatives are used to manage risks
38	Information on Risk management committee
39	Information on Assets-liability management committee
40	Information on Risk management structure

F	Credit Risk Exposure (08):
41	Disclosure on the magnitude of an institution's credit exposure on an aggregate basis
42	Information on credit risk management structure
43	Quantitative information on gross loan positions
44	Disclosures about the quality of the current loan and other counter party exposures with quantitative information
45	Amount and details of problem loans and other assets or details by internal risk ratings
46	Disclosure of credit rating system/process
47	Ageing schedule of past due loans and advances (NPA)
48	Disclosure about risk management process (use of risk-mitigating tools such as collaterals, guarantees, netting agreement, managing concentrations)
G	Market Risk Exposure (04):
49	General descriptions of market risk segments
50	Disclosures on value-at-risk (VAR) for interest rate exposure
51	Disclosures on value-at-risk (VAR) for foreign exchange exposure
52	Disclosures on value-at-risk (VAR) for trading and derivatives securities exposure
H	Interest Rate Risk (03):
	Detailed quantitative information about the nature and extent of interest rate-sensitive assets, liabilities and off-balance sheet exposures including
53	(a) Averages
54	(b) Breakdown of fixed and floating rate items for liabilities
55	(c) Assets
I	Currency Risk (03):
	Summarised data for:

56	Significant concentrations of foreign exchange exposure by currency
57	Broken down by assets and liabilities
58	Maturity of foreign currency assets and liabilities
J	Liquidity Risk Exposure (03):
59	Information about the firm's available liquid assets as well as sources and uses of funds
60	Information on concentrations of depositors and other fund providers
61	Maturity information about deposits and other liabilities
K	Accounting Policy Review (02):
62	Discussion on accounting policy
63	Disclosure of accounting standards uses for accounts
L	Key Non-financial Statistics (08):
64	Age of key employee
65	Details of branch location
66	Number of branches
67	Number of new branches during the year 2002-03
68	Information on branch computerisations
69	Information on ATMs
70	Location of ATMs and their address
71	List of top five shareholders of the bank
M	Corporate Social Disclosure (04):
72	Sponsoring public health, sponsoring of recreational projects
73	Information on donations to charitable organisations
74	Supporting national pride/government - sponsored campaigns
75	Information on social banking activities/banking for society
N	Others (08):

76	Chairman's/MD's report
77	On-line banking facilities
78	Information on credit card business
79	Information on international banking facilities
80	Information on welfare of employees
81	Information on ISO 9001: 2000 certification
82	Graphical presentation of performance indicators
83	Performance at a glance -3 years

Appendix 6

List of mandatory items in total disclosure index

A	Balance sheet items (13)
1	Capital and its breakdown
2	Reserve and Surplus and their breakdown
3	Deposits and their breakdown
4	Other liabilities and provision and their breakdown
5	Cash and Balance with RBI and their breakdown
6	Borrowing and its breakdown
7	Balances with other banks and their breakdown
8	Money at call and short notice
9	Investments and their breakdown
10	Advances and their breakdown
11	Fixed assets and their breakdown
12	Other assets and their breakdown
13	Contingent liabilities and their breakdown
B	Profit and Loss Account Items (07)
14	Interest earned and their breakdown
15	Other income and its breakdown
16	Interest expenses and their breakdown
17	Operating expenses and their breakdown
18	Auditor's fee
19	Directors' fee and allowances
20	Net profit/loss for the year
C	Board's Report (05)
21	Director's report
22	Narrative statement of company's affairs
23	Amount of dividend recommended
24	Narrative discussion of material changes and commitments
25	Narrative discussion of any changes occurring during the financial year
D	Corporate Governance (44):
26	Report on Corporate Governance
27	A statement on the philosophy on code of governance

28	Composition of Board of Directors
29	Category of directors
30	Details of attendance of each director at the BOD meetings
31	Number of BOD meetings held and date
32	Classification of directors as executive or outsiders
33	Information on management/executive committee of the board
34	Composition of Audit Committee
35	Basic details on the chairman of audit committee
36	Number of meetings held and date
37	Brief description of terms of reference of audit committee
38	Information regarding remuneration committee
39	Information on remuneration to all the directors/MD
40	Name of the director heading the shareholders' Grievance committee
41	Name and designation of compliance officer
42	Number of shareholders' complaints received so far
43	Number not solved to the satisfaction of shareholders
44	Number of pending complaints
45	Location and time of last /three AGMs held
46	Disclosure of special resolution passed in last three AGMs
47	Details of voting pattern
48	Disclosure of the person conducting the post ballot
49	Disclosure on materially significant related party transactions
50	Disclosure of accounting treatment
51	Details of non-compliance, penalties imposed by SE or SEBI
52	Disclosure of information on half-yearly report sent to each shareholder
53	Disclosure of information on the quarterly result/press release to website
54	Disclosure of information on presentations made to institutional investors/analysts
55	Disclosure of the current AGM, date, time and venue
56	Disclosure of financial calendar
57	Disclosure of the date of book closure
58	Disclosure of the dividend payment date
59	Disclosure of the listing information on stock exchanges
60	Disclosure of the stock code

61	Disclosure of the market price data
62	Disclosure of the performance
63	Disclosure of information on registrar and transfer system
64	Disclosure of information on share transfer system
65	Disclosure of information on shareholding pattern
66	Disclosure of information on distribution of shareholders category wise
67	Disclosure of the profile of directors appointed during the year
68	Auditors' certificate on compliance with condition of corporate governance
E	Management Discussion and Analysis (08):
69	Report on Management Discussion and Analysis (MDA)
70	Disclosure of narrative discussion on industry structure and development
71	Narrative discussion of opportunities and threats
72	Disclosure of performance on segment or product-wise
73	Narrative discussion of outlook
74	Disclosure of information regarding risks and concerns
75	Disclosure of information on internal control system and adequacies
76	Discussion on financial performance with respect to operational performance
77	Discussion on material development in HR including number of people employed
F	RBI Guidelines (24):
78	Capital adequacy ratio - Tier I and Tier II
79	Percentage of shareholding of government/RBI
80	Percentage of net non-performing loans to net advances
81	Related party disclosure
82	Break-up of provisions and contingencies appearing in profit and loss account
83	Amount of subordinated debt
84	Interest income as a percentage of working funds
85	Non-interest income as a percentage of working funds
86	Operating profits as a percentage of working funds
87	Return on assets
88	Business per employee
89	Profit per employee
90	Date on ALM - Maturity pattern of assets/liabilities
91	Movement of NPAs

92	Exposure to sensitive sectors
93	Movement in provision for depreciation on investment
94	Movements in provision for NPAs
95	Information in respect of restructuring etc. undertaken during the year
96	Cash flow statements - AS 17
97	Related party disclosure - AS 18
98	Methods of fixed assets valuation
99	Method of fixed assets depreciation
100	Segment reporting
101	Notes to the accounts

Appendix 7

List of Items in Corporate Governance Disclosure Index

A. BOARD OF DIRECTORS (7)	
1	A brief statement of company philosophy on the code of governance
2	Composition of the board of directors
3	Category of directors
4	Details of attendance of each director at BOD meeting
5	Number of BOD meetings held and date
6	Classification of directors as an executive or an outside director
7	Last AGM held and name of directors present
B. AUDIT COMMITTEE (4)	
8	Composition of the audit committee
9	The nature of the chairman of audit committee (i.e non-executive independent director)
10	Meeting and attendance of the year
11	Brief description of the terms of reference of the audit committee
C. REMUNERATION COMMITTEE (2)	
12	Remuneration policy
13	Details of all remuneration to all the directors
D. SHAREHOLDERS' GRIEVANCE COMMITTEE (5)	
14	Name of non-executive director heading the shareholders' committee
15	Name and designation of compliance officer
16	Number of shareholders' complaints received so far
17	Number not solved to the satisfaction of shareholders
18	Number of pending complaints
E. GENERAL BODY MEETING (4)	
19	Location and time of the last three AGM
20	Disclosure of special resolution passed in the last three AGMs
21	Disclosure of the person who conducted the post ballot
22	Producer for postal ballot
F. DISCLOSURES OF RELATED PARTIES (3)	
23	Disclosure on materially-significant related party transactions
24	Disclosure of accounting treatment, if different from AS

25	Details of non compliance, penalties imposed by SE or SEBI
	G. MEANS OF COMMUNICATION (3)
26	Disclosure of information on half yearly report sent to each household of shareholders
27	Disclosure of information on the quarterly result/press release to website.
28	Disclosure of information on presentations made to institutional investors/analysts
	H. GENERAL SHAREHOLDER INFORMATION (14)
29	Disclosure of the AGM, date, time and venue
30	Disclosure of the financial calendar
31	Disclosure of the date of book closure
32	Disclosure of the dividend payment date
33	Disclosure of the listing information on stock exchanges
34	Disclosure of the stock code
35	Disclosure of the market price data
36	Disclosure of the performance
37	Disclosure of information on the registrar and transfer system
38	Disclosure of information on the share transfer system
39	Disclosure of information on the shareholding pattern
40	Disclosure of information on the distribution of shareholders' category wise
41	Disclosure of the profile of directors appointed during the year(i.e. name, address, qualification, nature of appointment, experience, other directorship)
42	Address for correspondence
	L. Others (4):
43	Auditors' certificate on compliance of condition of corporate governance
44	Disclosure regarding risk management
45	Whether MD and A is a part of the annual report
46	Disclosure of Contingent Liability
	M. Voluntary Corporate Governance Items (11)
47	Detail about the chairman (other than name/title)/background of the chairman/academic/professional/business experiences
48	Details about directors (other than name/title)/ background of the directors/ academic/professional/business experiences
49	Number of shares held by directors
50	List of senior managers (not on the board of directors)/senior management structure
51	Background of senior managers
52	Details of CEO's contact address

53	Are the independent directors well defined
54	Nature of chairman of the board of directors
55	Directors' engagement with/directorship of other companies
56	Picture of all directors/board of directors
57	Picture of chairperson only

Appendix 7

Comparative Statement of International Accounting standards/International Financial Reporting standards and Indian Accounting Standards (at July 1, 2006)

SL No.	International Accounting Standards (IASs)/International Financial reporting standards (IFRSs)		Indian accounting standards (ASs)	
	No.	Title of the standard	AS No	Title of standard
1.	IAS 1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies
2.	IAS 2	Inventories	AS 2	Valuation of Inventories
3.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 16 and IAS 38	AS 6	Depreciation Accounting
4	IAS 7	Cash Flow Statements	AS 3	Cash Flow Statements
5	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6	IAS 10	Events After the Balance Sheet Date	AS 4	Contingencies and Events Occurring after the Balance Sheet Date
7	IAS 11	Construction Contracts	AS 7	Construction Contracts
8	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income
9	IAS 14	Segment Reporting	AS 17	Segment Reporting
10	IAS 16	Property, Plant and Equipment	AS 10	Accounting for Fixed Assets
11	IAS 17	Leases	AS19	Leases
12	IAS 18	Revenue	AS 9	Revenue Recognition
13	IAS 19	Employee Benefits	AS 15	Employee Benefits
14	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government
15	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
16	IAS 23	Borrowing Costs	AS 16	Borrowing Costs
17	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures

18	IAS 27	Consolidated and Separate Financial Statements	AS 21	Consolidated and Separate Financial Statements
19	IAS 28	Investments in Associates	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
20	IAS 31	Interests in Joint Ventures	AS 27	Financial Reporting of Interests in Joint Ventures
21	IAS 33	Earnings Per Share	AS 20	Earnings Per Share
22	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting
23	IAS 36	Impairment of Assets	AS 28	Impairment of Assets
24	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets
25	IAS 38	Intangible Assets	AS 26	Intangible Assets
26		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39 and 40 and IFRS 7	AS 13	Accounting for Investments
27	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations
28	FRS 3	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations ⁶² Further, AS 10 deals with accounting for fixed assets retired from active use.

Source: www.icai.org

⁶² IASB has issued IFRS 5 and withdrew IAS 35, *Discontinuing Operations*, on which AS 24 is based. An Indian Accounting Standard corresponding to IFRS 5 is under preparation. After the issuance of this Indian AS, AS 24 is proposed to be withdrawn.