Voluntary Disclosure Practices And FII Flows - A Study of Selected Indian Firms

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INTRODUCTION

An empirical regularity in the field of international capital flows is 'home bias', where investors deviate substantially from their purchases of foreign stocks, particularly emerging market stocks, though there is a diversification benefit. Among many other factors like improved legal system, institutional capacity, liquidity of capital market etc., information asymmetry has been identified as one of the important factors behind this home-biasness of investors by many eminent researchers. When it is more costly for foreign investors than domestic investors to obtain information about a domestic market, foreign investors either will be less informed, and hence face higher risks of making misjudgments or they will pay higher prices to be as informed as domestic investors. Previous studies reveal that if investors make foreign investment decisions based on the trade-off between expected benefits (e.g., diversification gains) and expected costs (e.g., information costs), high information costs for foreign investors are likely to discourage foreign investments and ,therefore, reduce international capital mobility. Because it is more costly for foreign investors to search for private information, previous findings suggest that greater disclosure of value-relevant financial accounting information will reduce information costs more for foreign investors and ,therefore, reduce their information disadvantages.

Since the 1960s, several empirical studies on the effects of the disclosure of accounting information on capital markets have been produced. More recent works assessed the influence of accounting information on the international capital mobility. Unfortunately, there are few, if any, studies attempting to find a relationship between the disclosure of accounting information and international capital mobility in the Indian context. Attempting to fill this void, this study aims at contributing to the literature on the relationship between capital mobility and financial reporting environment in Indian context. The study is important because of the recent surge in international capital into the developing world as a result of the ongoing World Bank and IMF led economic reforms. These reforms have emphasized transparency and accountability, which are integral to corporate governance.

An integral part of a well-functioning equity market is the issue of corporate governance that encourages investment by minority shareholders. There is the participation by a broad range of minority shareholders - households, domestic institutions and foreign institutional investors (FII) in Indian equity market. To study the impact of corporate disclosure quality, which is one component of corporate governance, on the foreign capital flow, the researcher only considers FII flow as foreign capital flow as they are the minority shareholders who are mostly benefitted from good corporate governance. From 1992 onwards, India has experienced a substantial integration with the world economy. There has been a duality between India's path in financial globalization, and the evolution of the equity-market-dominated financial system. On one hand, since foreign portfolio flows were given the most flexibility as compared with other forms of capital inflows, this is likely to have a positive effect on the equity market in terms of availability of equity capital, the development of market liquidity and improved corporate governance. Conversely, the sophisticated institutional capacity and liquidity of the Indian equity market has served to help overcome home bias and attract foreign investment flows. As India has moved towards an equity-market-dominated financial system, the economic significance of openness on portfolio flows has become greater. Portfolio flows are linking Indian finance into the global financial system. Hence, a deeper understanding of India's financial globalization critically requires a deeper understanding of foreign portfolio investment. Most of the features associated with foreign ownership are driven by the fact that foreign investors typically are mutual funds or other institutional investors. Because of this reason also, the researcher considers FIIs rather than other foreign investors in this study.The unit of observation in traditional discussions about home bias has been the country. If the investors only do country-picking, and country characteristics are all that shape home bias, there should be no cross-sectional variation in foreign ownership of Indian firms. This is obviously rejected by the evidence. India has some firms with a very high FII ownership, and a large number of firms

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with zero FII ownership. Understanding why some firms are able to have substantial foreign shareholding while others do not could give us new insights into home bias. This motivates for an examination of the characteristics of firms, which explains the variation in foreign ownership. Such results can also be useful in addressing the question of an Indian firm which seeks to obtain greater foreign shareholding. Hence, the author approaches the phenomenon of FII inflows into India as an analysis of firm-level data.

RESEARCH OBJECTIVES

Bushman and Smith (2001) imagine a governance role for financial accounting information that arises from reducing information asymmetry between investors. They point out that although there are critical elements besides financial reporting in a corporate governance system, such as the board of directors, shareholder rights and top management compensation, financial reporting and disclosure is an important component of corporate governance system because it allows investors and other outside parties to monitor firm performance and contractual commitments. Following their path, this study is centering on the quality of corporate disclosure prevailing in India and its influence on foreign capital flow to India.

In India, the corporate disclosure regulatory framework mainly consists of provisions in the Indian Companies Act, 1956 as amended from time to time, SEBI listing requirements and the Accounting Standards issued by the ICAI made mandatory for the purpose. However, particularly large and publicly traded leading companies have gone beyond those minimum requirements. It is true that some leading corporate players have started following comparable international practices on their own (example: Reliance), though majority adopt the same when either compelled by law or by market forces. Reporting information voluntarily has become a norm for large companies. Companies compete with an extensive amount of business information voluntarily to establish competitive advantage in the capital market. Hence, in this study, the author aims to establish a firm-level relation between the voluntary disclosure level and FII flows in India, if any, in the post liberalization period. The dependent variable of the study is the FII flows and the independent variable is quality of corporate voluntary disclosure. The other factors like size of the company, liquidity, ownership structure etc., which can have impact on FII flows (supported by previous studies) are treated here as control variables.

Accordingly, the author will test the following hypothesis:

H_1: The Degree Of Voluntarily Disclosed Accounting Information Affects Positively The FII Flows.

LITERATURE REVIEW

In the international finance literature, it is often believed that at least part of the home bias can be accounted by the information advantage of local investors. There have been both theoretical models (Hasan and Simaan, 2000; Hatchondo, 2004) and empirical literatures (Aggarwal et al.,2002; Dahlquist and Robertsson, 2001; Choe et al., 2004; Ahearne et al., 2004; Bae, Stulz and Tan, 2005; Malloy, 2005; Edison and Warnock, 2003; Lang, Lins, and Miller, 2003; Hau, 2001) explaining the relationship between asymmetric information and home equity bias.

In the previous studies, the concept of disclosure is operationalised by means of 'disclosure index', quantifying the types of data disclosed by corporate borrowers deemed relevant to investors. Disclosure index is the measurement of level of reporting by a company. The model includes information on financial and non-financial matters related to the past, present, and future of the corporation that may be relevant to investment decision-making, and which listed companies may or have to disclose. The indexes used in the previous studies were voluntary disclosure index (Ahmed, 2005; Barako et al., 2006), mandatory disclosure index (Hasan and Karim, 2005) and the combination of both (Kamal Kant 2002) although, most of the studies are on voluntary disclosure index.

Information about a corporation can be disclosed to investors in several ways but almost all of the previous researches have identified annual reports as the principal communication device available to companies and think it should serve as a good proxy for the level of disclosure provided by any firm across all disclosure avenues (Botosan 1997; Patel et al., 2002). Going by their logic, this study is also restricted on disclosure to annual report only.

In the previous studies, the items included in the disclosure index are selected on the basis of mainly the following criteria:-

- *An extensive review of prior studies* (Singhvi & Desai, 1971; Ahmed, 2005).
- *Discussion with financial and accounting experts and analysts*. (Singhvi & Desai 1971, Kamal Kant 2002)

☸ *In-depth study of the annual reports of the leading companies over the period of study* (Ahmed, 2005 and Kamal Kant, 2002).

Research in Indian financial reporting is relatively limited. In an early study by Singhvi (1967), he found that the quality of disclosure in India was inferior to that in the US at that time (1964-65). A comparison of financial reporting by Indian and UK companies by Marston (1986) showed that disclosure in the UK was better than in India. A survey of accounting practices carried out in the 1970s by Das Gupta (1977) concluded that most of the companies in India provided minimum information required by law. From a study of 50 large companies in the public and private sectors, Chander (1982) concluded that there was an improvement in the disclosure practices of these companies in 1984-85 over 1980-81. In a survey by La1 (1992), 45 per cent of Indian investors disagreed that financial information given currently in company annual reports was adequate for investors. Narayanaswamy (1996) describes the impact of economic liberalisation in India on financial reporting. After the programme of economic reforms initiated by the Government in 1991, Indian companies have started raising resources in international capital markets. Portfolio investment by foreign institutional investors is now allowed. It has been argued that the degree of internationalisation of the economy is a determinant of the quality of financial reporting. Radebaugh and Gray (1993) suggest that as the degree of internationalization of the economy increases, financial reporting systems tend to move towards internationally accepted benchmarks. Since Indian companies have functioned for a long time in a closed and highly regulated economy, they have had little incentive to incorporate international advances in financial accounting and disclosure in their domestic financial reports. According to Ahmed (2005), in India, the last decade has experienced profound change in corporate financial reporting practices. The present trends are to make annual reports attractive, and include varied information not only relating to what has already happened, but what is going to be the likely future, in spite of the uncertainties involved. The management report; business analysis; corporate governance; intellectual capital, brand valuation, economic value added (EVA) and market value added (MVA); environmental, energy and social issues; globalisation of accounts; segmental reporting; consolidation of accounts; and financial ratios are the areas with respect to which the contents of annual reports have started changing (Kamal Kant 2002). Managers of individual firms may voluntarily increase disclosure to attract more and more domestic as well as foreign investors. On the other hand, countries may improve their mandatory disclosure rules and governance requirements to market themselves to foreign institutional investors. Finally, there is literature review on FIIs in India. International portfolio flows, as are commonly known as Foreign Institutional Investment (FII) flows, refer to capital flows made by individual and institutional investors across national borders with a view to creating an internationally diversified portfolio. FII flows were almost non-existent until 1980s. Global capital flows were primarily characterized by syndicated bank loans in 1970s followed by FDI flows in 1980s. FII investment as proportion of a developing country's GDP increases substantially with liberalization as such integration of domestic financial markets with the global markets permits free flow of capital from 'capital-rich' to 'capital-scarce' countries in search of higher rate of return and increased productivity and efficiency of capital at the global level. In India, under the liberalized foreign exchange transactions regime, the results were dramatic. Dependence on aid has vanished and foreign direct investment (FDI), foreign portfolio investment (FPI), external commercial borrowings (ECB) and non-resident Indians (NRI) deposits dominate the capital flows. Among these again, there has been a gradual shift away from debt components to equity flows (the proportion of non-debt has gone up from about 5% in the second half of the 1980s to over 40% during the 1990s) which has been broadly in line with international developments (Sikdar, 2006). India, supported by her strong economic fundamentals, has become one of the attractive destinations for FII flows in the emerging market space today. The expansionary effect of various reform measures on FII flows over the years can be evaluated from the fact that net (i.e., gross purchases minus gross sales) FII flows into India have risen sharply over the past decade (Chakraborty 2007).

METHODOLOGY

☸ **Universe And Sample Of The Study :** The private sector companies ranked according to the average market capitalisations in the BT-500 list published by the magazine 'Business Today' constitute the universe of the study. The Mumbai-based Centre for Monitoring Indian Economy (CMIE), who has been entrusted the task of making such comprehensive list of top 500 most valuable companies, began with a universe of companies listed in BSE. Then they separated public sector units from private companies. All those companies whose stocks were thinly traded are eliminated. After that, the daily market capitalization of each company has been aggregated and this aggregate is

divided by the number of days the scrip was traded to compute the company's average market capitalisation. Then they ranked the 500 most valuable private sector companies by this average market capitalization. According to previous researches, since foreign investors are interested to invest in large stocks, the large companies are the focus of our study. It has also been seen that the FII ownership (which is the measure of foreign ownership in this study) of top 500 companies constitute 93% to 96% of overall FII ownership in all listed firms over the period of this study. From this top 500, the author again excluded the financial companies as they prepare their annual reports according to their different statutes and specialized nature of operations and financial disclosures. Since, the study period is of eight years (ranging from 2000-01 to 2007-08), the author got the BT-500 lists for all these eight financial years excluding the financial companies. After that on the basis of the availability of the annual reports of those companies, the author constituted the sample. However, for the purpose of analysis, the author wanted to have the balanced panel data, which needs a fixed sample over the study period. By taking the common companies from all the years of the study period, that fixed sample has been constituted which finally came down to 43 companies.

☸ **Database And Data Collection :** 'Sansco services' and individual company websites are the sources wherefrom the author collected the annual reports of the companies for the relevant period. The information obtained from the annual reports will be used to determine the disclosure level of the selected companies as per the index so developed for the purpose. The annual reports and the CMIE Prowess database are the sources of information on FII ownership for each company and other firm level factors like size, liquidity, ownership structure etc. that might influence the FII flows.

☸ **Development of Voluntary Disclosure Index- Independent Variable :** Voluntary Disclosure Index (VDI) has been developed to measure the voluntary disclosure level of any company which is used in all the eight years of this study. The VDI is used as the explanatory variable in the regression analysis. The information contained or items included in the voluntary disclosure index have been primarily selected on the basis of the review of literature on disclosure indexes developed by earlier researchers and also by thorough study of the annual reports of the companies. A total of 32 items have been included in the index. These 32 items have been grouped into two broad categories called financial information and non-financial information as disclosed in the following table:

Classification of Voluntary Disclosure Index Items

	Broad Category	No. of items
A.	Financial information	9
B.	Non-financial Information	23
	Total	**32**

Source: Voluntary Disclosure Index. (A complete voluntary disclosure index appears as Appendix)

The scoring of items in VDI has been made in the following way. If an information item of the disclosure index is disclosed in the annual report, full credit is given to the concerned company by awarding a score 'one'. On the other hand, if an item is found to remain undisclosed, the concerned company has been penalized by awarding a score 'zero'. However, in certain cases, there is variability in the amount of details disclosed by the companies in respect of some information items. In cases of such partial disclosure, partial credits are awarded. However, in all cases of partial rewarding, a consistency in the approach (i.e., for same amount of details presented by companies, awarding equal amount of score) has been attempted for all the sample companies.
Sum of the obtained score for each item is converted into voluntary disclosure score as a whole for the concerned company in the following way:

VDI = Total no. of items appearing in the annual report / 32

☸ **FII Ownership - Dependent Variable :** Firms report FII ownership which is available from annual reports. FII ownership includes all shares held by non-residents irrespective of where they are located. For each firm, the FII ownership as of the end of the financial year (which is generally March 31 for Indian firms) is taken.

☸ **Control Variables :** In this subsection, a number of firm-specific attributes have been described briefly that are documented in earlier research as being associated with foreign investment. These variables are treated as control variables in the regression analysis where the firm-level relation between the voluntary disclosure level and the FII flows in India are analyzed.

1. Size: This variable is simply the market value of the firm's shares at the end of the year.

2. Liquidity: Turnover rate is a measure of the market liquidity of the firm's shares.
3. Book-to-market : The book-to-market ratio is measured as the book value of equity divided by the market value of equity as of the end of the fiscal year.
4. Beta: Beta measures the systematic risk of a stock.
5. Promoters' Holding: It represents the ownership structure where there is high concentration of insiders. 'Promoters' Holding' is calculated as the percentage of outstanding common shares that are held by insiders.
6. Foreign listing: This dummy variable takes a value of one if the firm's shares are listed abroad. Otherwise, the value is zero.

❅**Procedure :** The author used panel regression and followed random effect model on the basis of Hausman Test for the purpose of analyses.
The Model has the following functional form:

$$Y_{it} = \alpha_1 + \alpha_2 X_{it} + \Sigma\beta_j C_{jit} + u_{it}$$

Where i =1…….43; j = 1.......6; t = 1, 2…8 (2001-2008)

Y_{it} = FII ownership of the i-th firm in time period t
X_{it} = Voluntary disclosure score of the i-th firm in time period t
C_{jit} = Control Variables for the i-th firm in time period t
u_{it} = Error term

❅**Time Effect :** Since my data set consists of both space as well as time dimension, hence, the author can also allow for time effect on account of factors like share prices, tax policies and other external effects which shifts over time. Hence, such time effect has been considered in the analysis through introducing time dummies one for each year. Since in the given analysis, the author has a total of 8 years, hence he has considered 7 time dummies dt_2, dt_3, dt_4, dt_5, dt_6 and dt_7. The first year has been considered as the base year. Hence the equation can be rewritten as:

$$Y_{it} = \alpha_1 + \alpha_2 X_{it} + \Sigma\beta_j C_{jit} + \lambda_0 + \lambda_1 dt_2 + \lambda_2 dt_3 + \lambda_3 dt_4 + \lambda_4 dt_5 + \lambda_5 dt_6 + \lambda_6 dt_7 + u_{it}$$

In the analysis, λ_0 is the base intercept for the first year and λ_1, λ_2, λ_3, λ_4, λ_5, λ_6 and λ_7 are differential intercept coefficients, which denotes by how much the original intercept of the time dummy dt_1 varies from the other remaining seven time dummies.

RESULTS

In this study, the author has run panel data analysis, which is a form of Multivariate regression analysis which considers both space as well as time dimensions in it. Now since my set of data consists of both space as well as time dimension, hence he has considered Panel Data Model as the most appropriate for our analysis. The author runs the following panel Data analysis using GRETL software package. Now as the observations can be described as being a random sample from a given population (i.e., BT 500, as mentioned above), he can perform both fixed effects and random effects regressions. By conducting Hausman Test, the author chose provisionally to use random effects regression. After that, the Breusch-Pagan test indicated the presence of random effects and the author finally concludes that he should be using random effects regression.

OUTCOME

NULL HYPOTHESIS: The Degree Of Voluntarily Disclosed Accounting Information Is Invariant With The FII Flows To The Companies.
Model: Random-effects (GLS) estimates using 344 observations

Included 43 cross-sectional units
Time-series length = 8
Dependent Variable: FII

Variable	Coefficient	Std. Error	t-statistic	p-value	Significance
const	19.4368	3.92225	4.9555	<0.00001	***
VDI	0.579469	0.174719	3.3166	0.00101	***
Promoters_holdi	-0.152931	0.0370902	-4.1232	0.00005	***
Market_Cap_	-2.94332e-05	1.56787e-05	-1.8773	0.06136	*
B_P	-0.329367	0.500051	-0.6587	0.51057	
Beta	-9.24924	3.25036	-2.8456	0.00471	***
Foreign_Listing	4.38779	2.44822	1.7922	0.07401	*
Turnover	0.000117075	0.00151098	0.0775	0.93829	
dt_2	-0.412461	0.956463	-0.4312	0.66658	
dt_3	-1.63003	0.972177	-1.6767	0.09455	*
dt_4	1.47358	1.01256	1.4553	0.14654	
dt_5	3.72858	1.05641	3.5295	0.00048	***
dt_6	6.15787	1.08718	5.6641	<0.00001	***
dt_7	5.9137	1.09244	5.4133	<0.00001	***
dt_8	4.55133	1.12913	4.0308	0.00007	***

If the value of t statistics computed is significant, then null hypothesis is rejected.

If the value of t statistics computed is insignificant, then null hypothesis is accepted.

☸ In case of the independent variable, VDI, the null hypothesis is rejected and the variable is highly significant, which indicates that it does induce a change in FII flows to the companies. The coefficient in case of VDI is positive in sign indicating that there is direct relation between VDI and FII.

☸ In case of the control variables, Promoters'_holding, Market_Cap and Beta, the variables are significant, indicating that they do induce a change in FII flows to the companies. However, the coefficients in these cases are negative in sign indicating that there is an inverse relation between Promoters'_holding and FII, Market_Cap and FII, and also Beta and FII.

☸ In case of the control variables, B_P and Turnover, the null hypothesis is accepted, which indicates that changes in B_P and Turnover do not induce any change in FII flows to the companies. Thus, the author says that these variables are insignificant.

☸ In case of the Foreign listing dummy, the author observed that it is significant, which indicates that there is a listing effect on the FII flows to a company, i.e., if any company is listed in a foreign stock exchange, then it does induce a change in FII flows to the companies. The coefficient in this case is positive in sign indicating that there is direct relation between Foreign_Listing and FII.

☸ In case of the 7 time dummies (dt_2, dt_3,…, dt_8), the author observed that the time dummies for the years 2002 and 2004 are insignificant and the remaining time dummies are significant. It implies that there is a time effect on the FII flows to the companies for the years 2003 and 2005 to 2008 i.e. it changes over time. However, for the other years, there is no time dummy effect.

MANAGERIAL RELEVANCE OF THE STUDY

The study can be useful for the managers in improving its disclosure with the aim of enhancing shareholder value, and satisfying the interests of other stakeholders also. As investors are the most important users of information disclosed in the annual reports of the companies, this helps them in making informed choices. By using the disclosure measurement mechanisms developed in this study, the large investors like financial institutions; corporate houses; and other institutional investors can benefit in making assessment of corporate performance. Apart from the financial information, the other issues like the employees related information, environmental and social issues have also to be considered, as the same build image of a company, which pays the investors in the long run. It has been established in my study that voluntary disclosure level and FII holdings are positively and significantly related. Hence, managers of the firms who want to seek foreign capital to promote more growth of the firm have to improve their disclosure quality voluntarily.

CONCLUSION

There is pervasive evidence that individuals and institutional investors favour stocks of their own country. The evidence suggests that the lack of portfolio diversification is based on rational behavior. It also points towards the presence of informational asymmetries in financial markets. This paper examines the relationship between one of the firm-level policies relating to information asymmetry and foreign institutional holdings in India during this decade. India as an emerging market exhibits wide variation in country-level and firm-level policies that potentially affect foreign investment flows. Foreign capital plays an important role in promoting economic growth with developing financial systems. By using a rich dataset on equity ownership and firm-specific attributes, the author has characterized foreign ownership in Indian firms in great detail. The author found that foreign investors allocate a disproportionately high share of their funds to large firms. The evidence also suggests that foreign ownership is related to firms' presence in the international markets, through listings on other exchanges. Moreover, foreign investors seem to prefer firms with a widespread ownership, a characteristic which again is most likely to be fulfilled by large firms. Finally, empirical evidence suggests that firm-level policy related to greater transparency and disclosure is positively associated with foreign institutional investment. This finding suggests that disclosure can potentially mitigate a country's other institutional deficiencies that affect foreign institutional investment. The author has examined the adoption of high quality voluntary disclosure policies as mechanisms for Indian firms to attract foreign institutional investment. The results show that, over and above other firm characteristics, foreign institutional investors allocate their assets largely to firms in India that have better voluntary disclosure practices. This finding highlights the important role of high-quality disclosures in attracting foreign institutional investments over and above the fact that the firm is traded in foreign countries.These results suggest that in India, steps can be taken at the firm-level to attract foreign capital and create an environment conducive to foreign institutional investment. Firms that wish to opt-out of their home country regime to attract capital also have to improve their disclosures quality. These results are relevant for firms in India seeking foreign capital to help promote economic and firm growth.

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APPENDIX

Voluntary Disclosure Index

I] *FINANCIAL INFORMATION*

1. Summary of financial results
2. The financial highlights for a number of years
3. Statement of sources and application of funds
4. Value added Statement
5. Economic Value Added (EVA)
6. Brand Valuation
7. Human resources Valuation
8. Current-cost statement
9. Key Ratios

II] *NON-FINANCIAL INFORMATION*

1. Chairman's Statement / MD's Report
2. Business Mission, Plans, Policies and Strategies
3. Ethics policy / Value System
4. Brief history of the company
5. Organisation Chart / Structure
6. Description of principal plants
7. Discussion of marketing networks for finished goods
8. Market Share Analysis
9. Order backlog
10. Unit Sales
11. Information Technology efforts and initiatives
12. The country / world economy
13. Quality Management Policy and Strategy
14. Explanations of factors responsible for variations in performance
15. Important events of the year
16. List of Directors or Managers
17. List of largest shareholders
18. Voluntary adoption of accounting standard
19. Functional classification of employees
20. Knowledge management strategies
21. Working environment and safety
22. Attrition Rates
23. Corporate Social Responsibility