

CORPORATE VOLUNTARY DISCLOSURE QUALITY
AND ITS IMPACT ON STOCK LIQUIDITY AND FOREIGN
CAPITAL FLOW IN INDIA

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ABSTRACT

With the growing number of corporate scandals (viz., Lehman Brothers, Xerox, Arthur Anderson, Enron, WorldCom, Tyco, etc.), in the world during the recent decade, sound Corporate Governance is thought to be critical for retaining investors' confidence and for good performance. Improved Corporate Governance ensures improved transparency, stronger external monitoring, and greater investor protection. A KPMG survey on 'The State of Corporate Governance in India: 2008' shows *improvement in financial and other disclosures* receives the highest votes among other factors, in order of their importance, for the improvement of corporate governance. As traditional financial reporting models might not provide enough information, like information on company's intellectual capital and the value of their intangible assets, discretionary disclosure became important to the corporate governance process in order to provide an unambiguous picture of corporate performance and the market value of the company. Previous researchers have established that companies, all over the world, have a tendency to raise voluntary information flow with rising levels of business complexity, instability and volatility, for the benefits of investors and financial markets. Such disclosures are intended for reducing the information asymmetry among managers and investors and provide clarifications about

long-term business sustainability. In this scenario, the first objective of this study is to see the trend in corporate voluntary disclosure practices in India during this decade, which is crucial for reducing information asymmetry between investors. For the purpose of the study a voluntary disclosure index have been developed, which has been applied to the annual reports of the companies in India, to measure the extent of their voluntary disclosure practices. The results of the study will have practical implications for analysts and investors to understand the trend in the quality of financial reporting practices in India which is one of the bases of making investment decisions as it allows investors and other outside parties to monitor firm performance.

India is the focus of this study, because of its unique background as an emerging market economy with rapidly growing capital markets. The Indian capital markets have both increased in importance and are competing to be among the leading stock market locations in Asia. Due to liberalization as more and more companies start focusing on foreign capitals for financing in India, they start competing with extensive amount of business information voluntarily to establish competitive advantage in the capital market. But in India, listed companies are usually controlled by family groups who hold many of the senior positions and also own a large proportion of the shares. In comparison with companies with wider share ownership, family-owned companies do not have much incentive to disclose information over and above the mandatory requirements since the demand for public information disclosure is relatively weak in those companies. This structural characteristic of the Indian stock markets provides a countervailing force to the rising pressures for internationalization and global transparency. So not only is more

research needed on Indian capital market, but also an evaluation of disclosure behavior of Indian companies is expected to be insightful.

Consistent with the previous literature, the second research objective is to see whether voluntary disclosure is positively related to stock liquidity in Indian context. As equity market gets stuck by weaknesses in transparency and information disclosure policies, economic theory advocates that higher disclosure should reduce the information asymmetry between corporate managers and outsiders, and this in turn increases stock liquidity. Using a sample of Indian listed firms between 2001 and 2008, we document evidence of the effect of disclosures in reducing information asymmetry by investigating the relation between firm's disclosure policy and liquidity in equity markets. Consistent with the theoretical prediction, the use of the Amihud (2002) illiquidity measure provides evidence in favour of a positive impact of disclosure on share liquidity.

With global financial integration, emerging markets have become increasingly more attractive destinations for international investors who look for higher returns than their own developed markets while diversifying their risk. Usually, due to location and language barriers, foreign shareholders are prone to face more information asymmetry than their domestic counterparts. Previous researches have demonstrated that companies participating in international capital market have a preference for higher voluntary disclosures than companies with domestic operation only. *Ceteris paribus*, a positive association exists among foreign ownership and voluntary disclosure. Hence, the third research objective of this study aims at contributing to the literature on the relationship between international capital mobility and corporate reporting in Indian context. In India, since the middle of 2003, the considerable increase in the FII (Foreign Institutional

Investment) has made it the most important source of portfolio investment. As among foreign investors FIIs are the minority shareholders and being minority they are mostly benefited from good corporate governance, this study establishes the firm-level relation between the voluntary corporate disclosure and FII flows in India over the last decade. Regression methodology using panel data is followed for the purpose of analysis.

