VOLUNTARY CORPORATE FINANCIAL DISCLOSURES AS STRATEGY:
Case Study of an Indian Company

BY

S. Venkatesh

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Please address all correspondence to:

S. Venkatesh
Assistant Professor
Indian Institute of Management
Bannerghatta Road
Bangalore - 560 076
India

Fax: (080) 6644050

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Prof. S. VENKATESH
Indian Institute of Management Bangalore
Bannerghatta Road
Bangalore 560 076
India

email svenkat@iimb.ernet in

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ABSTRACT

Voluntary Corporate Financial Disclosures (henceforth voluntary disclosures) are such information disclosures made by firms as are not required by laws or regulations. Much of the existing literature on voluntary disclosures have focused on the question as to why should firms make voluntary disclosures or on the question of what are the characteristics common to firms making voluntary disclosures. The question of why do firms make voluntary disclosures has not received adequate attention in the literature. This paper attempts to answer the question of why do firms make voluntary disclosures by doing an in depth case study of an Indian company operating in the Financial Services sector. The voluntary disclosures made by the company in its annual report of 1995-96 were the focus of the investigation.

The paper presents a review of the literature on voluntary disclosures in Section 2. Section 3 is a description of the regulatory framework governing financial reporting by Finanoial Service companies in India. Section 4 describes the methodology. Section 5 provides a background of the company and describes the specific voluntary disclosures made by the company under study. Section 5 presents the analysis. The concluding section presents some generalisations and directions for future research.

The additional disclosures made by the case company represent a major shift in the company's disclosure policies. The disclosures collectively communicate the poor financial state of the company. The disclosures result in the company reporting a large loss and in a substantial write down of its assets. Casual observation would lead us to believe that companies adopt an approach of gradually increasing the levels of voluntary disclosures. Evidence from the case suggests that major shifts in the level of voluntary disclosures are likely to be associated with a shift in corporate strategy and/or a change in top management. The absence of any linkage between top management remuneration and financial performance of the company can facilitate disclosures which have negative implications for the reported financial performance and position of the company. Disclosures are used to both communicate strategy and as an element of strategy The results of the analysis are related to the model of disclosure process proposed by Gibbins, Richardson and Waterhouse (1990).

1.0: INTRODUCTION:

1.1: Voluntary Corporate Financial Disclosures (henceforth voluntary disclosures) are such information disclosures by corporates as are not required by laws and regulations. Accounting literature has adequately covered the issue of why firms should make such voluntary disclosures, the consequences of such disclosures, and the firm characteristics that are associated with such disclosures. An important issue in this context that has not received adequate attention in literature is why firms do make voluntary disclosures. A related issue is how do firms decide what to disclose voluntarily. There is enough evidence to show that firm behaviour is not often predictable based on extant theoretical position and empirical evidence Thus, for example, despite overwhelming evidence in support of the theoretical position and supporting empirical evidence that "accounting cosmetics" which have no effect on a firm's underlying cash flows have no impact on firm value, managers in firms continue to engage in a variety of "accounting cosmetics" to manage earnings. What is called for here is a change in approach to studying firm behaviour. As Palepu (1987) rightly points out, conventional empirical research using large samples and statistical methods, can miss out the rich detail that can be unearthed from a detailed study of a single firm Such studies can in turn lead to a richer theory of Accounting.

1.2: In consonance with this view, this paper reports on a detailed case study of an Indian Non Banking financial company (NBFC)[1]. This company's Annual Report to its shareholders for the accounting year ended March 31, 1996, contained disclosures that were far more extensive than those made in its annual Reports of earlier years I define disclosure here to include not only the qualitative statements in the Annual Report but also certain rules of measurement which had an impact on the numbers reported in the financial statements. Many of these disclosures were voluntary in nature i e., they were not required under the existing rules and laws nor were they dictated by custom. Overall, these disclosures had the impact of considerably reducing earnings compared to that reported in the previous accounting period. The disclosure practices adopted were also long term in nature in the sense that the company cannot switch from the newly adopted practices without incurring substantial costs in the form of negative perceptions about the company in the market place. My investigation was intended to address the issue of why did the management of the company decide to make such voluntary disclosures. I have attempted to identify the conditions, both internal and external to the company, which created a supportive ambiance for such disclosures

1.3: Following the literature review in the next section, I provide a brief overview of the regulatory framework governing financial reporting in India NBFCs. Section 4 describes the research methodology. Section 5 provides a background of the company and describes the specific voluntary disclosures made by it. Section 6 presents the analysis. Section 7 presents some generalisations and directions for future research.

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[1] NBFCs are companies providing financial services such as leasing, hire purchase portfolio management and merchant banking services They do not provide commercial or retail banking services

2.0: REVIEW OF LITERATURE:

2.1: Why <u>should</u> firms make Voluntary Disclosures ?

Lev (1992) lists several reasons why firms should make voluntary disclosures:

Correcting Misvaluations: Since the source of misvaluations is information asymmetry, such misvaluations can be mitigated by making appropriate disclosures. Since misvaluations can be costly to a firm, resulting for e.g. in reducing the incentive effects of a stock option, firms have an incentive to mitigate such misvaluations

Enhancing Liquidity: Firms whose securities are thinly traded face a higher cost of capital, since investors trading in relatively illiquid securities demand higher returns. Existence of information asymmetries is a major reason for illiquidity, which can be tackled by improved disclosures.

Changing Shareholder Mix A firm can increase the visibility of its securities and the demand for them among individual investors by communicating more through mass media

Deterring Political and Regulatory Intervention A well planned disclosure policy of "conservative" accounting techniques and information on R&D costs can act as a deterrent to regulations aimed at reining in firms perceived as making "excessive" profits

Gaining Competitive Advantage Disclosures can be used as "market signals" that can be used to deter potential competition The function of disclosure viewed this way is more a tool of competition, than to remove information asymmetries

Despite such evident benefits of disclosures, firms exhibit a singular lack of enthusiasm for making disclosures Lev (1992) reports a very modest level of voluntary disclosure even among the 100 largest US companies and appears to be at a loss as to why this should be so. Lev's observations suggest that there could be factors, many of them firm specific, other than those listed above which determine the disclosure practices adopted by individual firms

2.2: What are the characteristics that distinguish firms making voluntary disclosures?

Choi (1973) examined the relationship between a firm's decision to enter the European capital market and its level of financial disclosure. Using a sample of 18 companies Choi found that over a 5 year period covering 3 years before and five years after the issue, firms raising capital in the European capital markets significantly improved their quality of disclosure compared to firms that did not raise capital in the European capital markets. Johnson and Khurana (1994) find that a majority of the issuers of debt under the Securities Exchange Commission's Rule 144A make significant financial disclosures to rating agencies ,which they are not otherwise required to do under the Securities Act, 1933 Using a sample of 67 Malaysian companies traded on the Malaysian Stock Exchange, Hossain, Tan and Adams (1994), find support for their hypothesis that more of the sample firms which were listed on the London Stock Exchange have higher levels of voluntary disclosures than firms which are listed only on the domestic stock exchange. Several studies report a positive relation between company size and voluntary disclosures For e.g. Mckinnon and Dalimunthe (1993) find for a sample of 65 diversified Australian companies that large companies are more likely to voluntarily disclose segmental information than are small diversified companies. Chow and Wong Boren (1987) found, in a sample of 52 Mexican firms, support for their hypothesis that larger firms make more extensive voluntary disclosures.

The large sample studies do not address some issues that can enhance our understanding of a firm's disclosure policies Some of these studies do not examine the nature of voluntary disclosures made by individual firms. Thus we do not know whether all large firms make the same kind of voluntary disclosures and if disclosures made by individual firms differ, what are the causes of such differences. By focusing on firm characteristics, the large sample studies do not give adequate attention to the managerial incentives to make extended financial disclosures Admittedly, this is not the issue of concern in such studies, studies of individual firms can enhance our understanding of factors relating to the firm and its management which can affect the level of voluntary disclosures.

2.3: How do firms make disclosure decisions?

Gibbins, Richardson and Waterhouse (1991) address the questions of what are the determinants of disclosure output. Disclosure output comprises of six categories of components one of which is the information set that is disclosed Their study covers all kinds of financial disclosures both required and voluntary They define Disclosure position as "a relatively stable preference for the way disclosure is managed". Disclosure position can be marked by Ritualism which is the "propensity toward uncritical adherence to prescribed norms" or Opportunism which is " the propensity to seek firm specific advantage in disclosure of financial information". Both Ritualism and Opportunism can exist in the same firm for different kinds of disclosure. Disclosure position is influenced by a set of internal antecedents such as corporate history, corporate strategy and internal politics, and a set of external antecedents which can be institutional and market. A firm's disclosure output is influenced by its Disclosure position as also by the specific disclosure issues, by the role played by external consultants and advisors and by the and by the extent to which responsibility for the management of disclosure process is assigned to particular positions within the organisation and by the extent to which external demands for information are channeled through organisations that claim to represent third party interests. They provide some validation of their model by linking measures of disclosure output to various measures of the factors that are seen to be influencing the disclosure output. Their approach accommodates the differential levels of disclosure output by different firms and seeks to provide explanations based on a combination of factors peculiar to each firm. Their model is also intended to be predictive. The model, in which the linkages among the various elements are yet be completely defined and the measurement of whose various constructs and empirical testing remain to be done, offers a valuable reference for developing a detailed understanding of a firm's decision to make voluntary disclosures. In their concluding section the authors suggest that " the concept of a corporate disclosure position or strategy seems to offer considerable potential for explaining voluntary financial disclosure"

3.0: THE REGULATORY FRAMEWORK GOVERNING FINANCIAL REPORTING BY NBFCS IN INDIA:

3.1: Almost all large firms providing non banking financial services in the India take legal form as limited liability companies. Financial reporting by limited liability companies is mainly regulated by the provisions of the Companies Act, 1956, (henceforth, The Act). The provisions of the Act relating to Accounting and Audit are built around "true and fair" accounting which characterises financial reporting in the UK, among other countries. The Act also prescribes the format of financial statements in its schedules.The Act does not explicitly recognise NBFCs as a separate category of entities for financial reporting regulation. The Act prescribes various kinds of penalties to be imposed both on companies and on the managers responsible, for non compliance with the provisions of the Act.

3.2: Financial reporting by listed limited liability companies are also governed by the listing agreement with the stock exchanges.Clause 32 of the listing agreement with any stock exchange in India, requires a listed company to publish cash flow statements. Under Clause 41 of the listing agreement with any stock exchange in India, a listed company is required to publish unaudited half yearly results.Under Clause 43 of the listing agreement with the stock exchanges ,companies are required to publish a comparison of the projected gross profit, net profit, and Earnings per Share as shown in the offer document in a public offer of shares with the actual performance, in the report of the directors in the Annual Report. The consequence of non- compliance with the provisions of the listing agreement, is delisting of the company's securities from trading on the exchange

3.3: The third element of the regulatory framework governing financial reporting by NBFCs are the standards and guidance notes issued by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI). Currently, there are 15 Accounting Standards (AS) which have been issued by the ASB. 13 of these are mandatory. 2 are recommendatory. Non compliance with mandatory ASs in preparing the financial reports will attract qualification in the Auditors' Report Recommendatory Standards are persuasive in character.

In addition to the standards, the ICAI also issues Guidance Notes and statements. The Guidance Notes are persuasive in character, too. They are issued as a prelude to an Accounting Standard. An important Guidance note that influences on Financial Reporting by NBFCs is the Guidance Note on Accounting for Leases.

The Guidance Note on Accounting for Leases covers the subject of accounting for leasing transactions by both the lessee and the lessor. The note defines a finance lease as a "lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset". A lease other than a financial lease is called an operating lease. Most leases in India are structured as financial leases. We will confine our discussion here to that portion of the guidance note which deals with accounting in the lessor's books of a financial lease. The asset under finance lease will appear as a fixed asset in the books of the lessor.

Central to the accounting for financial leases by the lessor is the determination of the interest rate implicit in the lease The implicit interest rate is the rate at which the present value of the lease rentals equals the fair market value of the asset financed at the inception of the lease. Using this implicit interest rate, the finance income in each rental installment is determined. The remaining portion is defined as the annual lease charge. The annual lease charge is matched as an expense against the rental income for each year. The annual lease charge appears in the income statement partly as depreciation on the asset and to the extent of the balance as a lease equalisation charge or lease equalisation credit depending on whether the annual lease charge is in excess or in deficit of the statutory depreciation, respectively. The lease equalisation charge or credit is created by a corresponding entry in the lease terminal adjustment account which is carried in the balance sheet. The Lease Terminal Adjustment Account is adjusted against the book value of the asset at the termination of the lease.

Two issues are noteworthy in the treatment prescribed by the Guidance Note . One is that the reporting entity can shift the income recognised on the lease to a period of its choice covered by the lease. The second issue is that the reporting entity can provide depreciation on the asset at rates prescribed by the Act which are far less than that prescribed under the Income Tax Act on the basis of which taxable income is computed Since, under the current regulatory framework for financial reporting in India, firms are not required to provide for deferred tax liability, the practice of adopting different methods and rates in providing for depreciation, to compute reported and taxable incomes, can substantially inflate the post tax reported earnings per share These issues will be discussed further in the sections that follow

3.4: The Reserve Bank of India (RBI), which is the country's Central Bank, also plays a part in regulating financial reporting by NBFCs The RBI has prescribed what it terms "prudential norms for income recognition, accounting standards, provisioning for bad and doubtful debts. " for NBFCs with net owned funds of INR 5 million and above and registered with the RBI. Adoption of these norms is a condition for continued registration of the NBFC

We discuss here two important features of the RBI norms which have an impact on the financial statements of NBFCs. The first is the concept of a Non Performing Asset (NPA). The RBI notification prescribes the conditions under which the various types of assets of an NBFC are to be treated as non performing. The assets under consideration are in the nature of receivable on various accounts such as lease rentals, hire purchase installments, etc. An asset should be classified as non performing if the debtor has defaulted on principal/ interest payment for a period exceeding 6 months The notification then goes on to prescribe the rules for income recognition and provisioning with respect to NPAs. No income should be recognised on an accrual basis on an NPA. The notification also prescribes the extent of provisions to be made for the non recoverability of the NPA. The extent of provisioning is related to the period for which the asset has remained an NPA.

The second important feature of the RBI notification is the treatment prescribed to account for investments in financial assets such as shares, debentures, etc. The prescription of the notification is in line with the provisions of AS 13. It requires current investments to be valued at the lower of cost or market value and long term investments at cost. The reporting entity is also required to account for any permanent diminution in value of the long term investments.

3.5: A feature of the regulatory framework of financial reporting in India, which affects all reporting entities in general is the delinking of income reported in the annual report and the taxable income. There are several items of revenues and expenses that are treated differently in computing reported income and taxable income. Some of these, like depreciation, are now familiar in many countries. Others such as exemption from tax of income on exports are peculiar to a few countries such as India. Even though reported income is different, and is usually more than taxable income, there is no requirement for companies to provide for deferred tax liability. For firms that earn a large portion of their revenues from activities such as leasing, the reported income is likely to exceed the taxable income for several years in succession.

4.0: RESEARCH METHOD:

The case study method was used in this study. The case study is an appropriate research strategy when "a 'how' or 'why' question is being asked about a contemporary set of events, over which the investigator has little or no control". (Yin, 1989.) The primary research question in this study and the circumstances of the subject company the satisfy the criteria for the adoption of the case method

Identification of the case company preceded the formulation of the research question. The starting point of the study was a chance encounter with and a detailed of the company's Annual Report for the financial year 1995-96. The research question " Why did the company make the voluntary disclosures in its Annual Report?" followed Given the relatively nascent stage of our understanding of the process of decision making on financial disclosures in firms, no specific proposals were developed for testing The study is exploratory in nature The unit of analysis is the company

The main construct used in this study is voluntary disclosures. Voluntary disclosures have been defined as those not required by regulation However, it is possible that factors other than regulation may constrain the discretion available to the company in making financial disclosures Thus, some of what is defined voluntary disclosure in this study may not be really voluntary We adopt the limited definition of voluntary disclosure in this study and make no attempt to identify factors other than regulation which define voluntary disclosures This limitation is imposed by the single case study approach adopted in this study.

The data requirement was identified as explicit statements through different media on the reasons for the voluntary disclosures and various events and outcomes that could provide an insight into the implicit reasons for the voluntary disclosures. Multiple sources of data were used. The different sections of the Annual report formed an important source of data to understand the nature of the voluntary disclosures made and to gather the reasons articulated by the top management for making such voluntary disclosures. Data was gathered from the annual reports of other similar companies to provide a basis for comparing the case company's disclosures with what was seen as the norm in the industry

Interviews were conducted with both the CFO of the company and the consultant to understand the motivations for making the voluntary disclosures. The interviews were unstructured The broad question that was posed was " Why did the company make these voluntary disclosures in its Annual report of 1995-96?" The total time spent on the interview was 5 hours. Clarifications, mostly relating to terminology used, were sought of the interviewee from time to time in the course of the interview. The interviews were recorded and the recordings were used to produce transcripts which were analysed. The contents of the transcripts were vetted with the interviewees and rectification were made where necessary.

Several internal documents of the company were perused to seek evidence supporting the assertions made in the interview. These documents were also examined to understand in detail several of the issues which were mentioned in the passing during the course of the interview. No documentary evidence could be examined to support the assertions by the CFO regarding how the Board of directors were persuaded to adopt the idea of making such extensive disclosures. Interviews with the members of the Board could not conducted due to limitations of time and resources.

In addition, data was obtained in informal sessions with executives of other NBFCs as to what they thought of the disclosures made by the case company in its Annual report.

Since the report of the Directors in the Annual report was the starting point of the data collection, the analysis of the data collected comprised of verifying the assertions made the report The report made strong references to the woeful state of the financial markets and the need to institutionalise best practices, and the case company's move to change its corporate strategy The voluntary disclosures were described as part of the larger effort to institutionalise corporate best practices. They also appeared to be linked to the shift in the company's corporate strategy Analysis of the data that was subsequently collected was done to evaluate the support provided by such data for the preliminary understanding of the reasons for the voluntary disclosures from the report of the directors.

5.0: THE COMPANY AND ITS VOLUNTARY DISCLOSURES:

5.1: TGFL was incorporated on the 27th of November, 1989. The company is engaged in providing Financial and Leasing services. The company was promoted by a prominent media group. TGFL started operations in retail and corporate lending, Merchant Banking and Money Market related activities. In April 1991, it diversified into Portfolio Management Services.

5.2: For the year ended 31st March, 1996, TGFL reported a loss, after prior period adjustments, of Rs. 230.9 millions. This represented a considerable deterioration in performance compared to the corresponding previous period for which the company reported a profit of Rs.90 million. The decline in profits was despite an increase in the company's reported revenues from Rs.360.6 million to Rs.385.2 million. The major reasons for the decline in performance were increased provision for bad debts (Rs.60.2 million against Rs.5.3 million for the previous year), deferred tax liability of Rs.3 million (no deferred tax accounting was done till the previous year) and prior period adjustments (Rs.139.3 million against Rs.Nil in the previous year)

The prior period items, which are the single major reason for the decline in the reported earnings comprised of 5 items. They were. Depreciation on leased assets (Rs.51.1 million),charge on stock on hire (Rs.23.8 million), operating loss portfolio management scheme (Rs.6.7 million), and deferred tax liability (Rs.55.5 million).

5.3: A description of each of these items is provided in this sub section

5.3.1: Provision for Bad Debts :

As explained in the previous section the provisioning for Bad Debts by companies such as TGFL which are classified as NBFCs is governed by the norms set by the RBI As per the RBI norms, an asset must be provided for once it becomes a Non Performing Asset (NPA) An asset becomes an NPA when no income is received on an account for more than 6 months and 30 days The extent of provisioning is dependent on the number of days that the asset has been classified an NPA In relating the provisioning to the period for which the asset has been classified as an NPA the RBI has made time as the single factor that determines the extent of provisioning

In an internal document, TGFL argues that factors other than time can contribute to a client defaulting TGFL developed its own scheme for provisioning taking into account 5 factors a) Financial Performance of the debtor measured in terms of cash flows, b) The context, particularly the industry in which the debtor is operating, c) The quality of management of the d) The debtor's behaviour in terms of its repayment record and e) The quality of documentation of the credit granting process

The provisioning for bad debts based on the scheme developed by TGFL will result in profits (losses) which will be lower (higher) than what it would be if the provisioning had been done using the RBI norms For the accounting year 1995-96 the provisioning under the scheme developed by TGFL was Rs 60 million Under the RBI norms the provision would have been Rs 10 million The norms developed by TGFL for provisioning for bad debts are more stringent and conservative compared to those prescribed by the RBI except in one respect The RBI norms prescribe a general provision of 10% on all substandard assets The norms developed by TGFL do not include this 10% general provision

Explaining the TGFL decision, the Chief Financial Officer (CFO) said, "The RBI norms are easy to circumvent" Under the RBI norms, companies that do not wish to show an asset as an NPA can accept cheques from such borrowers which can subsequently be allowed to bounce Since the RBI's definition of an NPA is based on the time lapse between the date that the payments were due and the date on which the payments were received, the receipt of a cheque, even if it is one that is certain to bounce, would be sufficient for the lender to classify the assets as "performing" The CFO of TGFL explained that his company wanted to go beyond the RBI's definition and define an NPA more meaningfully. Commenting on the RBI norms, TGFL observes in an internal document that the norms are directly related to the recoverability of debt on the assumption that as time increases, the probability of recoverability decreases Such a rationale, observes the TGFL document, ignores the Account Manager's judgment based on a direct interaction with the borrowers TGFL considers its provisioning norms as part of what it terms Corporate Best Practices

A comparison of the provisions under the various categories of assets under both the RBI norms and TGFL's best practices shows that in some categories provisioning based on best practices is higher than that prescribed by the RBI and in other cases the provisioning is lower than that prescribed by the RBI On the aggregate, the provision as per best practices is higher than that based on RBI norms for the year ended 31-3-96 In the event of the provision as per

RBI norms being more on the aggregate than the provision as per best practices, the company would have to provide for the aggregate amount arrived at using the RBI norms

In the notes to Accounts in its Annual Report for the year ended 31-3-96, the company explains

"The Company is required to make provisions for non performing assets as per the guidelines for prudential norms prescribed by the Reserve Bank of India for income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/ investments The guidelines require the NBFCs to provide for doubtful debts in case of all sub standard assets The provisioning for non performing assets has been done on a more conservative basis than that prescribed by the Reserve Bank of India Guidelines "

In adopting these conservative provisioning norms TGFL has adopted measurement and disclosure practices that seem to go beyond what is prescribed by relevant regulation Such provisioning practice is also not customary as was found by an examination of the relevant accounting policies adopted by a sample of other firms in the industry In the process the company is making voluntary disclosures of the management's assessments about the quality of the company's assets

5.3.2: Deferred Tax Liability:

As mentioned in section 3, the regulatory framework of Financial Reporting in India does not require reporting entities to provide for deferred tax liability even though the rules governing computation of reported income are different from the rules governing computation of taxable income For most companies, especially those that are making large investments in depreciable assets, the present regulations facilitate reporting larger incomes in their annual reports than for taxable purposes

TGFL had not provided for deferred tax liabilities in any of its financial years till 31 3 95 For the financial year ended 31 3 96 TGFL voluntarily adopted the practice of providing for deferred tax liability For TGFL the principal item that gives rise to a difference between the reported and the taxable income is depreciation TGFL has provided a deferred tax liability only with respect to depreciation on its leased assets The deferred tax liability for a year is
(Depreciation for Income Tax - Principal recovery in lease rentals) x Tax rate

The adoption of the practice of providing for deferred tax liabilities resulted in an additional expense of INR.3 million on account of the current period and INR 55.5 million as a prior period item By adopting the practice voluntarily, the company has also committed itself to continuing the practice in the future

5.3.3: Depreciation on Leased Assets

This item resulted from a change in depreciation policy The earlier policy of providing depreciation only on the basis of the lease rentals due or received implied that the upfront management fees collected under the lease agreement, not being a lease rental, was not used as a basis to compute depreciation As a result, at the end of the lease period, a portion of the cost of the assets equal to the upfront management fees, remained as a balance in the asset account This practice had the effect of boosting the reported income The company saw this as a practice that did not correctly reflect the nature of the transaction. The consequent change in the depreciation policy resulted in a prior period charge and also increased the depreciation charged in the current period. The details of the change in the method of charging depreciation is not evident from the Annual report. The CFO, while explaining the nature of the change with a detailed illustration, admitted that the explanation in the annual report was omitted due to oversight.

5.3.4: Charge on Stock on Hire:

TGFL provided INR 23.8 million as charge on stock on hire for the year ended 31.3.96. The provision relates to assets with customers under hire purchase agreement. Under the hire purchase agreement, the ownership and possession of the asset is transferred to the hiree. The assets are carried in the books of the hiree who claims depreciation on them. The hirer - in this case TGFL- is entitled to the hire-purchase installments. The charge of INR 23.8 million reflects the company's doubts about recovery of the hire purchase installments. The additional provisions constitute a voluntary disclosure of the management's assessment about the quality of the assets.

5.3.5: Operating loss on Portfolio Management Scheme:

The Portfolio Management Scheme (PMS) is a fee based service provided by TGFL to its clients The clients entrust their funds with TGFL which then invests them in suitable assets and provides a return to the clients. The clients pay a fee to TGFL. TGFL had promised its clients a minimum rate of return on their portfolios. Due to adverse market conditions the company could not earn even the minimum returns promised to some of its clients. The clients obtained a directive from the stock market regulator to TGFL, asking the company to pay the minimum promised returns The payments which were made in the earlier years were not charged to income Instead, they were carried as an asset. In its accounts for the year ended 31.3.96 the company decided to write off these amounts to income. According to the CFO, the loss on PMS came to light during the course of a review of the receivables. The Board of directors was in favor of charging off the loss to income over several years. But the CFO's view that the loss be written off fully in the financial year ended 31.3.1996, prevailed. The loss appears in one of the expense schedules No description of its exact nature is provided anywhere in the Annual report The CFO said the omission of an explanation was due to an oversight.

5.3.6: Valuation of Investments:

In addition to the above, TGFL also changed its policy of valuing investments. Till the previous year, investments in shares, debentures etc. were valued at cost. The investments can be broadly classified into those that were quoted and others that were unquoted. Of the unquoted investments some were in government securities and others in private equity. The government securities formed about 8.5% of the total investment as at 31.3.95.

For the year ended 31.3.96, TGFL adopted the policy of valuing current investments on the basis of the lower of cost or market rule. Long term investments were valued at cost with provision being made for permanent impairment in value of any investment. This policy is in accordance with the relevant RBI notification and the mandatory Accounting Standard # 13 which came into effect from 1.4.95

In adopting the Accounting Policy with respect to investments, companies have considerable leeway on 2 issues:

a) On classifying an investment as long or short term.
b) On judging whether an impairment in value of a long term investment is permanent or not

Companies that do not wish to allow their reported incomes to be depressed because of adverse market conditions may successfully argue that their investments are long term so that the "lower of cost and market " rule is not applicable to valuing such investments. Such companies can also then attempt to convince their auditors that the impairment in value of the investments is not permanent This is common practice among many NBFCs. TGFL adopted conservative practices which resulted in large write offs for the accounting year ended 31.3.96 The company also reduced its holdings of investments considerably. On 31.3.94, the proportion of investments to total assets was 31.35%. In absolute terms the value of the investments was INR 201 million. On 31.3.95, the proportion of investments to total assets was reduced to 15%. But in absolute terms the value stood at INR 282 million. On 31 3.96, the value was down to INR 142 million and the proportion of investment to total assets was only 8.23%. The loss on valuation of securities was INR 30 million. In the financial year ended 31 3 96, the company sold 82% of what was classified as long term investments as at 31.3.95 The portfolio of unquoted investments in private equity which was carried at a cost of INR 35 million as at 31 3 95 was nearly all sold off The balance of unquoted investment as at 31.3.96 was only INR 6 million. There is suggestive evidence in the annual report that the sales of these investments were also effected at a loss It was not possible to ascertain either from the report or from the company the precise amount of the loss. Given the leeway in accounting for investments, most companies that do not wish to adversely affect their profits can adopt practices that do not record impairment in value of investments The company's judgment becomes critical in reporting the unquoted investments for unlike the quoted investments whose market values have to be reported proforma in the annual report, the unquoted investments can continue to be carried at cost till the company judges any impairment in its value to be permanent

5.4: I present below an analysis of the nature of voluntary disclosures made by TGFL.

5.4.1: The voluntary disclosures made by TGFL in its Annual Report for 1995-96 were all income reducing in nature Some of these, such as the new standards for provisioning, were an implicit admission of the liberal accounting policies of the previous years. Others represent the company's move to adopt what it had identified as corporate best practices. The effect on income was mostly on account of prior period items i.e.. additional changes arising from the change in accounting policies, which are attributable to prior years. Taken as a whole the new disclosures constitute a set of policies that are more conservative in computing income, compared to the policies of earlier years.

5.4.2: Prior studies of voluntary disclosures have focused on a single item of disclosure such as segmental disclosures or have used some form of disclosure index to distinguish among firms with different levels of voluntary disclosures In the case of TGFL, the set of voluntary disclosures in its Annual report of 1995-96 have to be viewed as a whole The disclosures appear to mark a break in the company's financial reporting practices Analysis of why the company made these disclosures can be best done by considering them as a whole and not as individual items. Anecdotal and causal evidence would suggest that the extent of voluntary disclosures increase gradually over time. The significant shift in Voluntary Disclosures of the kind found in TGFL's annual report of 1995-96 is relatively rare. It provides a unique setting to study the factors that influence decisions to make voluntary disclosures.

5.4.3: The Voluntary Disclosures made by TGFL also have long term implications. The company would have to incur substantial costs in terms of adverse impact on its image, were it to try to revert to its earlier level of disclosures. The company would have to continue its present disclosures and perhaps even improve on them in the future. In the interview, the chief Financial officer of the company claimed that the company was aware of the fact that the reversal of the newly adopted disclosure policies would not be costless. He also asserted that the company did not contemplate any going back on the enhanced levels of disclosures that it had adopted.

5.4.4: An examination of the annual reports of 5 leading NBFCs for 1995-96 reveals that none of them had made the kind of disclosures that TGFL had. These companies had continued with the liberal accounting policies and modest levels of disclosures that had been adopted by TGFL in its previous annual reports. In this sense, TGFL's disclosures mark a break from the industry practices. The Chief Financial Officer explained that the company was aware of its departure from current industry practices The company also realised that its earnings would compare unfavourably with those of other companies in the industry. He saw no option for the other NBFCs but to follow TGFL's example. He believed that the other NBFCs had put a lid on the problem and were waiting for the revival of the depressed financial markets. Such revival, which could see increase in value of investments in market securities or improve the chances of recovery of loans etc , was, according to him, based on optimism not supported by market conditions

6.0: Analysis:

6.1: The report of the directors of TGFL in the Company's annual report for the year ended 31/3/96, presents a striking contrast to the report for the year ended 31/3/95. Compared to the trite style of the report for the year ended 31/3/95, the report for the year ended 31/3/96 is almost philosophic in its approach. The report for the year ended 31/3/96 is also revealing of the strategy that the company intends to adopt. In describing the business environment for the year ended 31/3/96, the directors comment on the turbulent financial markets, inactive capital markets, volatile currency and money markets, increasing rates of default by borrowers, and rising cost of funds. The directors remark that as an emerging market, Indian financial markets. are characterised by inadequate development in regard to institutions, norms of behaviour among the players, and effective regulation. The directors' report does not include measures of market turbulence or capital market inactivity etc. In a sense that was commonly shared by most observers of a participants in the financial markets, the markets did deteriorate on various dimensions in 1995-96. But much of this, especially the inadequate development of institutions or the deplorable behavior of market participants were not peculiarly characteristic of 1995-96. The markets have for long been characterised as such. The significant thing is that the directors chose to comment on it in the company's annual report of 1995-96, though they make little or no reference to it in the 4 previous annual reports of the company. Part of the reason for highlighting the state of the market lies with the change in the top executive management of the company. For the rest, the observations on the state of the market are a prelude to a discussion of the company's new corporate strategy.

6.2: TGFL saw a change in its top executive management team in the year 1995-96. In August, 1995, nearly half way into the financial year, three new members were inducted into the company's executive management. Simultaneously, two key executives in the top management resigned from the company. The Board of Directors was reconstituted with two of the three new incumbents being inducted into the Board. The third was appointed the Chief Financial Officer. In making these top level changes, there is implicit acknowledgment of the failure of the company under the previous management. Though the company had been reporting profits, the promoters and the top management probably recognised the poor state of the company's finances

Of the three new inductees in top management, two were from NBFCs with previous experience in commercial banking and financial market operations. The third was from a commercial bank. The two inductees from a NBFC had built a reputation on their previous job for innovative practices which were aimed at bringing about changes in the unsatisfactory state of market practices

The new top management team also brought in the services of a consultant The role of the consultant is articulated in the Directors' report

> " The process of institutionalisation of best practices in the company has been initiated by articulating and documenting professional standards in all the areas of business and operations with the help of a well known consulting firm."

The induction of a new management team and the appointment of the consultant appear to be at least partly instrumental in making large scale changes in the disclosure practices of the company The newness of the management might have contributed in other ways, discussed below to the expanded disclosures and adoption of more conservative accounting practices by the company.

6.3: The "big bath" phenomenon which has found mention in the literature (e.g. Healy, 1985) refers to a decision by a company's management team to increase the loss reported in the current period by including all future possible losses that they can write off. For a new management team, the "big bath" is an effective way of wiping the slate clean and starting afresh. The losses that the management reports in its initial years in office, and most certainly within 8 months of assuming office, as happened in the TGFL case, are unlikely to be attributed to them. Such losses are more likely to be attributed to the previous management team. The "big bath" not only allows the new management team to start with a clean state by adopting practices such as ultra conservative provisioning and write offs, it also lowers the base level considerably from where it is easier to register substantial improvements in performance in subsequent years

Watts and Zimmerman (1986) observe that, given an earnings based compensation plan, manager's choice of accounting procedures as would shift reported earnings from future periods to the current period. The range of available choices can be restricted by regulation or by contract between the company and its managers. Despite such restriction, managers are likely to enjoy a wide latitude in their choice of accounting procedures in computing earnings. Subject to an overall ceiling of 11% of net profits after tax companies in India are free to enter into a contract with their managers which can provide a remuneration package including commission computed as a percentage of profits. The two members of the new top management team who have been appointed to the Board of TGFL have accepted the appointment on terms which do not include any remuneration linked to reported profits. The remuneration includes a flat salary, perquisites such as housing, leave travel concession and retiral benefits. The absence of any remuneration linked to reported profits runs contrary to trends in the Financial Services Industry in India. A survey of practices in 5 large NBFCs reveals that all of them compensate top management partly through profit linked commissions

6.4: The change in top management was accompanied by a change in the company's corporate strategy. Corporate strategy concerns two different questions: 1) What businesses the corporation should be in and 2) how the corporate office should manage the array of business units (Porter, 1987) In their report, the directors of TGFL clearly articulate their decision to convert TGFL from a fund based to a non fund based business. To quote:

"From the strategic perspective all the product-markets in which the company has been active are being reviewed as much for their contextual relevance as for their profitability. Given the evolutionary status of the market, it is expected that activities based on funds deployment will increasingly become non-viable from the point of view of this company "

The report then goes on to explain that the processes, products and people of the company were being oriented to " facilitate flow of funds in the market, rather than providing them " The articulation of the strategy to shift to non fund based activity is accompanied by a drastic decrease in the company's holding of equity shares and other securities

Explaining the company's decision to shift from fund based to non fund based activities, the Chief Financial Officer said that the new management inherited a portfolio of receivables of very poor quality. The previous management team had had as their agenda. lending. The company was holding large amounts of funds which had to be deployed. Junior functionaries in the company at the regional or branch levels were urged to lend as much as they could In the process, these functionaries not only lent to borrowers of doubtful creditworthiness but also slipped up the documentation. For e.g. some of the files of borrowers which were examined by the author showed that the only documentation that the disbursement officer had done was to file a photocopy of the cheque issued to the borrower. It was not surprising, therefore, that many of these debts turned bad. In the Chief Financial Officer's words, it was time for the company to change from a lending company to a recovering company. In doing this, the company adopted several measures- it retrenched nearly 50% of the employees who were on the rolls when the new management team took charge. It recruited new employees who were informed that their main task would be of collection of receivables. The companies initiated a series of innovative methods to recover outstandings. Among these was providing advisory services to borrowers who were in financial difficulties and negotiating a revival package with other creditors on behalf of the borrowers. This aspect of the company's strategy is articulated in its Annual report of 1995-96. To quote

"In line with the understanding of the context and the conceptualisation of the future directions of the company, the action plan for the next financial year focuses on (among other things) reduction in non-performing assets "

6.5: The company's adoption of voluntary disclosure practices coincide with the change in top management and the change in corporate strategy. The reporting practices adopted by the company in drawing up its financial statements for the year ended 31/3/96, are described as being motivated by the company's reading of the future state of the market and the company's efforts at identifying and institutionalising best practices in all aspects of its operations. To quote from the annual report:

"While the impact of these actions (i.e , adoption of expanded disclosure practices) on the balance sheet is clearly negative, though not adverse in terms of the balance sheet risk, the policy of the company suggests no other alternative. In fact, any other presentation of accounts is unlikely to reflect the true picture "

The Directors' arguments for the expanded disclosure practices constitute an adverse opinion of what TGFL had practiced in the past and also of how other companies in the industry reported their financial position and performance, since few other companies follow even a part of TGFL's new set of practices Thus, the expanded disclosures are used by TGFL not only to set itself apart from its competitors but also from TGFL itself as it existed till then This constitutes a tactical move to reap advantage of what can be seen as an adverse business condition NBFCs, given the nature of their business, rely to a greater degree than, say, manufacturing companies on their image as reliable and trustworthy entities to gain competitive advantage in both the factor and the product markets TGFL's strategy can be expected to be effective in an industry in which most companies in India adopt not only liberal accounting policies and practices but are also known to follow questionable business practices For e g , even though there is an RBI imposed ceiling on the rate of interest payable to investors in debt instruments, most companies and mainly NBFCs, flout the norm by giving the investors large upfront commissions which increase the effective interest rates In a reference to this practice, the Directors' Report of TGFL says

" On the liability side, your company has decided to mobilise funds - as fixed deposits or through debentures- without incurring expenses other than interest and other **legitimate** transaction costs." (emphasis added)

Thus, the expanded disclosure practices are projected as a part of a larger programme of improving the business practices in the company. The large losses resulting from the newly adopted practices are implicitly justified as being due to questionable practices adopted by the company in the past and are delinked from the operation of the company in the financial year covered by the report. In the process, the new management team may have overstated the losses through excessive write offs etc. This can enhance the company's profits in the subsequent years if recoveries of these apparently bad debts are made The credit for the enhanced profits would accrue to the management responsible for the recovery

6.6: TGFL was a company in financial difficulty It had managed to report profits in the first 4 years of its operations With hindsight, it is obvious that this was possible only through recourse to liberal accounting policies and limited disclosures The quality of its assets had deteriorated substantially and it had adopted various measurement and disclosure rules which allowed it to report profits. Apparently, managers in the company had believed that the markets were not informationally efficient to " see through" the company's accounting practices. This belief could have been strengthened by the fact that other companies in the industry followed similar liberal accounting practices. The change in the top management coupled with their remuneration package being unlinked to reported profits provided conditions that were supportive of " full and fair" disclosure. The new management unveiled a new strategy for the company which involved making the company into a non fund based business from its current status as a fund based business. Concurrently, the new management also evolved a strategy of projecting the company as one that was reliable and trustworthy. The voluntary disclosures made by the company were a common feature of the new management's twin pronged strategy. On the one hand the new disclosure policies helped the company mark down many of the assets resulting from its fund based business. On the other hand the voluntary disclosures were projected as being characteristic of a company that was in the "process of institutionalising best practices"

6.7: No measures of the various constructs used in the Gibbins et al's model were developed in attempting to relate the findings of this study to the model. The attempt here is a limited one based on an understanding of the various constructs and an intuitive linkage of the constructs to the case study above. I have related the disclosure output of TGFL to the independent variables identified in the Gibbins et al study. Disclosure output is defined in Gibbins et al in terms of six components viz. information set, content, redundancy, timing, ex ante interpretation and ex post interpretation I use the idea of a change in disclosure output. Though TGFL's disclosure output is not defined and measured in terms of these six components, it is intuitively clear that the company's disclosure position has undergone a change. All of this change in disclosure output is in the nature of voluntary disclosures. My attempt here is to identify the independent variables in the Gibbins et al study which can explain the change in disclosure position of TGFL

TGFL management's disclosure position with respect to the company's voluntary disclosures can be described as opportunistic which is defined as " managerial predisposition to behave in a particular way, but through active stances in which disclosures are seen as opportunities to reap specific benefits by managing the disclosure process". The other dimension of a firm's disclosure position identified in the Gibbins et al study is ritualism which is defined as " uncritical adherence to prescribed norms for the measurement and disclosure of information" The two dimensions may coexist within the same firm for different kinds of disclosures

Gibbins et al identify three categories of internal antecedents (corporate history, corporate strategy and internal politics) and two categories of external antecedents (institutional and market factors) which can determine disclosure position and consequently the disclosure output. For a firm, it can be argued that a change in any of these antecedents can trigger a change in disclosure position and consequently the disclosure output. Evidence in this case would suggest that a change a firm's corporate strategy can cause a change in the firm's disclosure position. We highlight here the role of corporate strategy in determining the disclosure position. Corporate strategy appeared as a prominent antecedent factor in the case of TGFL. The exclusion of other antecedent factors in our discussion is not intended to diminish their role in determining the disclosure position. It merely reflects the peculiar circumstances of the case company.

Gibbins et al observe that strategic choices affect " how disclosure is managed, and preferences for a disclosure style may affect these choices". TGFL's decision to shift to non fund based business constitutes a strategic choice. As observed above, the company chose to use its disclosure practices to communicate strategy. A statement in the report of the board of directors articulating the company's intent to shift its corporate strategy could have the effect of committing the company to the chosen course. However, such statements backed by detailed disclosures which communicate the folly of the company's past practices put the issue beyond doubt. Thus, the disclosures not only communicate that the company was changing its business but also that it had gone wrong with its business in the past. The disclosures were also used to communicate the company's intent to evolve and adhere to what it called a set of " corporate best practices" which was presumably intended to improve the company's image in the markets. It appears, therefore, that how TGFL managed its disclosures was not merely prompted by its choice of strategy. The company's voluntary disclosures formed a critical element in the implementation of the company's new strategy.

What we have offered here is an extension of the model proposed by Gibbins et al. We have used the notion of a change in disclosure output of the same firm over time. The changes, which are a consequence of voluntary disclosures made by the firm adopting an opportunistic position, appear to be an element in the implementation of a changed corporate strategy.

7.0: Conclusions:

The contribution of the study is in identifying the significant role of Corporate Strategy in determining Voluntary disclosure practices. Financial Disclosures as are seen in this case are a credible way of communicating corporate strategy. Such use of Financial Disclosures by companies can be predicted by the incentive signalling theory of Ross (1979). For a company that sees its long term survival and that of the industry in changing existing ways of doing business and reporting profits and paying dividends, Financial disclosures with implications for current and future reported earnings, offer a credible communication vehicle. Such disclosures also set other companies in the industry thinking about their own practices and about the questions they can expect to encounter from investors and other stakeholders.

The shift in the company's strategy and the consequent disclosures coincide with a change in the top executive management. Even if the previous management team had continued with the company, it would have been a matter of time before the company was forced to shift the focus of its business and make complete disclosures of its financial state. It is open to conjecture as to what changes in strategy would the company have adopted and what form the disclosures would have taken had the old management team continued. The new management team had the advantage of being unlikely to be held responsible for the company's poor financial state. It used this advantage well, by its extensive disclosures of the company's business in the first year in office. The fact that its remuneration was not linked to reported earnings facilitated such disclosures further.

Major shifts in disclosure practices seem likely only under significantly altered business conditions, such as changes in industry and company strategy, supported by facilitating conditions, such as change in management, which are partly a consequence of the changed business conditions.

Generalisations are difficult at this stage. As a direction for future research, in-depth case studies of companies involved in a large scale change in disclosure practices as are described in this case, can help in identifying common factors which can add to our understanding of why do companies make voluntary disclosures.

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