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ECONOMIC THEORIES BEHIND CORPORATE INFORMATION DISCLOSURE

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Abstract: **The present paper is a conceptual study emphasizing on the concept of corporate information disclosure, its need in contemporary era and economic theories behind it. The corporate disclosure practices play a fundamental role in the economic process and are essential for maintaining the integrity and reliability of financial information. The corporate information disclosure by different companies is based on economic theories like agency theory, political cost theory, signalling theory, stakeholders theory, legitimacy theory and proprietary cost theory. These theories provide strong base to study the concept of corporate information disclosure. The resultant enhanced corporate disclosure helps them to make well-informed economic decisions to maintain the reputation of firm in the competitive centralised capital market and to protect the firms from the political pressures.**

Keywords: **Corporate information disclosure, India, Economic theories.**

1. INTRODUCTION

The subject of Corporate Disclosure which is also known as Financial Reporting, Corporate Reporting and Disclosure has attracted attention of various researchers, academicians, intellectuals, stakeholders during the recent years. Disclosure is a process of providing certain financial information to a wide variety of users relevant to their data needs concerning the performance of an entity (Datt, 1999). Its purpose is to disclose information in more meaningful and transparent manner. The information should be conveyed to stakeholder in the way they are seeking for their investment decision making. Lack of information can lead to spread of misinformation about a company that can harm its reputation and can lead to loss of stakeholder's confidence, trust and interest in the company.

The Indian economy has experienced a profound change in corporate financial reporting practices during the last decade not only in the information content of annual reports, but also in presentation. These changes are driven by the additional disclosure requirements prescribed through amendments to the Indian Companies Act 2013 by considerably amending disclosure requirements under the Securities and Exchange Board of India (SEBI) regulations and by additional disclosure requirements stipulated in the revised and new accounting standards issued by the Institute of Chartered Accountants of India (ICAI). These changes have forced the companies listed on Indian stock exchanges to disclose at least the minimum information in their annual reports as set out by the Indian legislation. However, particularly large and publicly traded leading companies have gone beyond the statutory requirements (Ahmed, 2005) to protect the interests of a caveat emptor. The number of regulatory authorities in financial markets (both capital and money markets) such as Department of Corporate Affairs (DCA), Ministry of Finance (MOF), Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) are giving stress upon disclosures under powers given by the Indian Companies Act, 2013; SCRA, 1956; SEBI, 1992; RBI Act, 1938 and Indian Banking Regulation Act, 1949.

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2. ECONOMIC THEORIES OF CORPORATE INFORMATION DISCLOSURE

The companies provide mandatory information as required by law to its stakeholders. Thy provide extended information beyond statutory requirement known as voluntary information to interested parties as this information is crucial for them to make investment decisions. The decision to disclosure mandatory as well as voluntary information to various stakeholders depends upon the theoretical background as to why the disclosure is significant to them. Therefore, various economic theories support the reasons for a company to disclose information to the public at large. The major objective of the financial information disclosure is to bridge the information gap between shareholders (principal) and managers (agent) by providing prior party with the relevant, timely and useful information for investment decision-making. It helps in reducing information asymmetry and thereby reduces cost of capital of a firm. The other objective is to mitigate the level of insider trading or reduce rumours and minimise the scandals in the capital market. The corporate information disclosure by different companies is based on economic theories like agency theory, political cost theory, signalling theory, stakeholders theory, legitimacy theory and proprietary cost theory.

2.1 Agency Theory

Agency theory models the relationship between the principal and the agent. It is defined as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some services on their behalf that involves delegating some decision-making authority to the agent” (Jensen and Meckling, 1976). In the context of a firm, the agent (manager) acts on behalf of the principal (shareholder) (Ross, 1973; Jensen and Meckling, 1976; Fox, 1984; Eisenhardt, 1989).

This separation of ownership and management results in costs which do not exist when the owner and manager is the same person. Jensen and Meckling (1976) categorised this cost as monitoring costs (expenses incurred by the principal to limit aberrant activities of the agent), bonding costs (expenses incurred to ensure that the agent does not undertake actions that are not in the principal’s interests) and residual loss (loss due to sub-optimisation by the agent of the welfare-maximisation objective).

The information asymmetry between managers and shareholders (owners) is a major issue. This theory gives explanation with reasons as to why information disclosure is made by the managers (see e.g. Firth, 1979; Chow & Wong-Boren, 1987; Cooke 1989, 1991, 1992; Hossain et al., 1994). Managers in the knowledge that shareholders will seek to control their behaviour through bonding and monitoring activities may have an incentive to try and convince shareholders that they are acting optimally and disclosure may be a means of achieving this. Theory predicts that agency costs will vary with different corporate characteristics such as; size (although some authors, such as Ball & Foster, 1982; question this), leverage and listing status. For example, agency theory would suggest that highly leveraged companies would disclose more information in order to satisfy the needs of debenture holders and trustees. Through greater disclosure companies attempt to reduce the cost of capital by reducing investor uncertainty. This argument may also relate to the company size if larger companies make greater use of debt because of tax advantages (Ahmed & Courtis, 1999). The large companies are more visible in the eyes of government, regulatory agencies and public at large and subject to high political costs. Those firms may employ financial information to reduce such risks or even costs (Inchausti, 1997).

2.2 Political Cost Theory

The political costs also influence the financial information disclosure. Political costs are associated with essentials for business continuity and life, according to legal requirements and customary and economic environment (Bushman & Piotroski, 2006). Political process theories suggest the use of accounting data to decide policy on subsidies for companies, fixing tax policy and prices in regulated industries. Companies which are politically visible and subject to high political costs may employ financial information to avoid these risks and may also execute accounting changes to reduce such risks or even costs (Holthausen and Leftwich, 1983).

The political cost hypothesis indicates that the bigger the political costs of the company, the more likely management to implement accounting policies to defer reported earnings from current period to future periods. This hypothesis brings politics into the option of accounting policies. Highly profitable firms absorb media and consumer attention, which increases in taxes and other regulations (Scott, 2014).

Therefore, the existence of contracting costs (agency and political costs) may be used to explain the attitude of companies towards the disclosure of information and choice among different accounting procedures (Watts and Zimmerman, 1978, 1986, 1990).

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2.3 Signaling Theory

The company follows the signaling theory to explain the financial information policy of a firm. The existence of information asymmetry between the firm and investors may produce the problem of adverse selection (Akerlof, 1970, cited by Inchausti, 1997). The firms may use financial information to indicate underlying reality and to influence external users in their decision-making (Inchausti, 1997). It may be argued that only good firms will use this instrument because if later on the signals were found to be incorrect the market would punish the firms (Morris, 1987 cited by Inchausti, 1997). Verrecchia (1983) suggests that corporate disclosure helps analysts and investors to predict future earnings, as corporate managers have to disclose value-relevant information.

However, the manager may exercise certain discretion by choosing timings and extent of information disclosure taking into account that no information may be interpreted as *bad news*.

2.4 Proprietary Cost Theory

The proprietary cost theory explains that the managers may withhold information for the fear of competitive disadvantage. *Disclosure cost* or *proprietary cost* including preparing and disseminating information as well as competitive disadvantage is important in making decision regarding information disclosure. 'In effect a proprietary cost introduces noise into the model by extending the range of possible interpretations of withheld information which is actually favourable' (Verrecchia 1983). The proprietary costs decrease with the increase in the size of a firm. Thus, it is optimal to produce more information to avoid traders reacting negatively to the withholding of information.

In short, Ball (1989) states that the accounting policy of a firm, its existence and form is determined by considerations of contracting efficiency. Therefore**,** firms with serious agency problems will spend more resources on contracting and monitoring than firms with limited agency costs (Maijoor, 1991). The same logic may be applied to political costs. Watts and Zimmerman (1986) state that the expenditure of resources on information improves the allocation of capital because more efficient firms receive more capital.

2.5 Legitimacy Theory

The application of legitimacy theory (Dowling and Pfeffer, 1975) in the context of information disclosure provides valuable insights into how organizations utilize information and communication to uphold their social and institutional legitimacy. Deegan (2002a) provides that, consistent with resource dependence theory (Pfeffer and Salancik 1978), legitimacy theory suggests that whenever managers consider the supply of the particular resource is vital to organisational survival, they will pursue strategies to ensure the continued supply of that resource. In this sense, legitimacy refers to the perception that an organization's actions, conduct and operational norms align with the broader societal standards, values and expectations. This element is of paramount importance for an organization's enduring viability and its acceptance within the various stakeholder groups it engages with including customers, investors, regulatory bodies and the general public.

Voluntary disclosures enable companies to project a positive image include CSR reports, sustainability initiatives, charitable contributions and codes of ethics (Guthrie and Parker, 1989). These signal that the firm cares about more than just profits, and acts responsibly towards various stakeholders. For industries like tobacco, oil and mining with negative perceptions, legitimacy-motivated voluntary disclosures aim to improve public reputation and counteract criticisms (Patten, 1992). Firms can justify actions, downplay risks and present solutions through such disclosures. By voluntarily reporting on environmental policies, community development and other social issues, companies seek to be viewed as legitimate entities contributing value to society at large (O'Donovan, 2002). This legitimacy protects their reputation, market position and social contract to operate.

By disclosing this information, organizations aim to demonstrate that they are meeting or surpassing societal expectations and contributing positively to their communities and the environment. This, in turn, helps legitimize their operations. Legitimacy theory acknowledges that organizations may not disclose this information solely out of altruism but as a response to stakeholder pressure. Stakeholders including consumers and activist groups may demand greater transparency regarding social and environmental practices.

Information disclosure, according to legitimacy theory is not just about sharing data but also about aligning organizational practices with prevailing norms and values. It allows organizations to show that they are sensitive to societal concerns. Non-disclosure or a lack of transparency in areas deemed important by society can lead to a legitimacy gap where the organization's practices are at odds with what is expected. This gap can erode trust and lead to reputational damage.

Stakeholders' perceptions of an organization's legitimacy are influenced by the extent and quality of its disclosures. When an organization successfully aligns its disclosures with societal values, it enhances its legitimacy. Legitimacy theory recognizes that organizations face a balancing act. They must meet disclosure expectations to maintain legitimacy but over-disclosure or disingenuous disclosures can also damage legitimacy if stakeholders perceive them as insincere or manipulative.

2.6 Stakeholder Theory

The stakeholder theory (R. Edward, 1984) emphasised on the organizational management and business ethics that can address morals and values in managing an organization. Stakeholder Theory is a view of capitalism that stresses the interconnected relationships between a company and their stakeholders including its customers, suppliers, employees, investors, communities and others who have a stake in the organization. The theory argues that a firm should create value for all stakeholders, not just shareholders.

The corporate sector can disclose information ethically that can help customers to make strong investment decisions. This theory is applicable in corporate social information disclosure studies where the companies are more responsible to the stakeholders while discharging their social responsibility. Thus, the stakeholder theory works on building relationships and value between a business and its various stakeholders (Freeman and Dmytriyev, 2021).

The discussion of agency and signalling theories explained a considerable overlap between the two. Indeed Morris (1987) explored whether these two theories are consistent, equivalent or competing by examining the necessary and sufficient conditions for both of them. Morris (1987) suggests that as the sufficient conditions for signalling theory are consistent with those of agency theory, the two theories are consistent. However, informational asymmetry, a necessary condition for signalling theory is not shared by agency theory (although it is implied) and therefore they are not equivalent, i.e. one is not implied by the other. Morris (1987) suggests that given this consistency between agency and signalling theory it is possible to combine them to yield predictions about accounting choices. Indeed, he concludes ` . . . the prediction of accounting choices can be improved by adding together the predictions from each theory.'

Therefore, the hypotheses related to the size of a firm, its profitability, listing status, leverage, ownership structure, audit firm size and nature of industry in the research related to their relationship with corporate information disclosure are derived from an application of agency theory, political cost theory and signalling theory. The stakeholder theory and legitimacy theory apply in the case of studies related to social, environmental and governance information disclosure.

3. A CASE FOR ENHANCED CORPORATE DISCLOSURE

Disclosure in the Indian corporate sector has gained significance during the last four decades after introduction of economic and financial reforms, allowing the foreign institutional investors to enter the Indian capital market and efforts by the regulatory authorities to bring Indian corporate sector in line with standards of International business community. Thus, globalised Indian economy demands for globalised financial reporting structure. Clause 49 of the listing agreement and Indian Companies Act, 2013 is a step in this direction. The SEBI, regulatory authority for stock exchanges in India has made norms for the listed Indian companies to bring them in competition with international capital market. It demands for exhaustive list of items of information to be included in the annual reports to the users to assist them in decision-making.

The need for enhanced corporate disclosure emerges from the fact that the mandatory disclosure along with voluntary disclosure can help the investor in economic decision- making in efficient way. The impression of a company that it is running well and contributing more to the economy lies in the point that to what extent the information is being disclosed to the investor in understandable form. A lot of changes have taken place in the information requirements of an educated investor. Now he is not satisfied with only profit figure of a company. He needs something extra that can satisfy his information needs. A company should communicate the required information to investors and not just what the law stipulates. Even the best-managed companies have a long way to go in this regard.

The various regulatory authorities in India have taken the steps towards this direction. Basically, the Indian Companies Act, 2013, prescribes in details the information to be disclosed by the companies in their annual report. Besides this the ICAI has also made mandatory the disclosure and compliance of accounting standards by the companies. SEBI has also amended its listing requirements to make enhanced disclosures mandatory for listed companies.

The transformation of Indian economy into knowledge-based economy has made it necessary to disclose information about intangibles and various risk-based financial instruments in the annual report. Thus, transparency and full adequacy makes an annual report purposeful.

The next question is why does corporate transparency matter? The answer lies in the fact that a feature of modern corporations is information asymmetry between insiders and outside stakeholders. It creates incentives for opportunistic actions by insiders. In a world of incomplete contracts, outsiders cannot fully protect themselves against such opportunistic behaviour. Corporate transparency matters to individual firms in order to minimise adverse selection (Verrecchia, 2001). If share market investors cannot distinguish good quality firms from bad quality firms, they will tend to treat all firms as being of *average* quality, which punishes good quality firms. Good quality firms thus have an incentive to leave the capital market to raise finance elsewhere on terms reflective of their higher quality, for e.g. from private sources leaving the market over represented by poor quality firms. In such state, financial reporting transparency can have signalling properties for good quality firms (Spence, 1973).

Corporate transparency matters to regulators for macroeconomic reasons – to restore confidence, expand capital markets and to encourage investment in an economy. Thus, the corporate transparency and fair disclosure adds to the creditworthiness of the corporate sector and in turn enhances its reputation and shareholders base in the economy. It ultimately leads to the wealth maximisation for the shareholders of the firm.

4. CONCLUSION

In nutshell, the disclosure of voluntary and mandatory items of information together under one roof (i.e. annual report) can protect the shareholders rights and interests. It helps them to make well-informed economic decisions to maintain the reputation of firm in the competitive centralised capital market and to protect the firms from the political pressures. Thus, the boundaries of corporate disclosure should be crossed to enhance its value and creditworthiness in the eyes of shareholders and various stakeholders.

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