

Do Board of Directors Ensure Quality of Disclosures in Annual Reports?

OPEN ACCESS

Manuscript ID:
MGT-2022-09034456

Volume: 9

Issue: 3

Month: January

Year: 2022

P-ISSN: 2321-4643

E-ISSN: 2581-9402

Received: 09.10.2021

Accepted: 25.11.2021

Published: 01.01.2022

Citation:

Jarwal, Devendra.
“Do Board of Directors
Ensure Quality of Disclosures
in Annual Reports?” *Shanlax
International Journal of
Management*, vol. 9, no. 3,
2022, pp. 17–25.

DOI:

[https://doi.org/10.34293/
management.v9i3.4456](https://doi.org/10.34293/management.v9i3.4456)



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Abstract

A company's published annual report is the primary channel of communication with shareholders and shareholders use these reports as a tool to monitor the activities of the Companies. The present study is an attempt to assess the effectiveness of annual reports in communication and its utility in monitoring affairs of the companies. The prime focus of this study is to rate management discussion and analysis on perceived risk factors of the company and the disclosure quality of risk perceptions of the management. The purpose of the study is to explore the quality of disclosures in the annual reports hence exploratory-qualitative analysis technique has been applied. Reports of selected companies were analysed and results were discussed with selected stakeholders to corroborate findings with the existing patterns in disclosures. The study concludes that the level of reporting is associated with stages of maturity of a company and during a larger phase of a company quality of disclosure remains irrelevant to management as well as to shareholders. Existing researches on the subject have identified various factors influencing comprehensiveness of disclosures in the annual reports while this research has explored a new theory of irrelevance in disclosing crucial risk-related perceptions.

Keywords: Corporate Governance, Disclosures, Annual Reports, Risk Management, Management Discussion, JEL codes:G30, G32, G34, G39

Good corporate governance is always based upon the degree of disclosure made by its executives to the stakeholders (Fung, 2014). Proper disclosure ensures transparency that eventually guarantees that decisions have been taken by complying with all rules and regulations (Parigi, Geeta, & Kailasam, 2004). Considering the inevitable role of disclosures almost every country has legislated upon mandatory disclosure requirements for corporate governance (Bhasin, 2010). Academic as well as empirical researchers consider good corporate governance from an ethical perspective and thus emphasised upon voluntary disclosures (Eng & Mak, 2003). There are some external factors that decide the degree and nature of disclosures by the corporate entities. These factors are provisions of corporate laws, auditing & accounting principles, need of investors, guidelines of securities market regulators, and information provided by other similar entities (Forker, 1992). Similarly, there are some internal factors that influence the degree and nature of disclosures by the corporate entities. These internal factors are managerial preferences, the composition of the Board of directors, and capital structure (Chen & Jaggi, 2000). These disclosures have led to abundant information flowing in the annual reports of the body corporate whether under mandatory obligations or voluntary motivations (Morunga & Bradbury, 2012). Annual reports of listed entities roughly consist of more than three hundred pages nowadays due to various disclosure requirements.

Annual reports are prepared for providing information to stakeholders. Except for the failure of few companies to prepare annual reports, almost every company is preparing and disseminating annual reports to the stakeholders. Still, society is witnessing various corporate governance failures.

Of course, the preparation and distribution of annual reports do not guarantee impeccable corporate governance. An annual report must contain statements indicating the status of preparation and adoption of risk management policy for the company. The disclosure on risk management policy must contain identification of elements of risk, if any, which in the opinion of the Board of directors may threaten the existence of the company (Jarwal, 2018). Point is that if annual reports are being prepared containing all the required disclosures then why stakeholders and authorities fail to sense probable corporate governance failures. Even in some of the cases the concerned company was perceived as an ideal company in terms of good corporate governance but out of sudden that entity failed and surprised everyone (Garima, Gupta, & Nagar, 2015). This phenomenon has cast some serious questions to enquire about behaviour of managers and stakeholders towards annual reports. Are stakeholders of a company really interested in reading all those pages or are they able to derive any conclusion from reading all those pages? These questions are from the stakeholders' perspectives.

From the managerial perspective, one may be interested to know whether the Board of directors really concerns about writing annual reports. Do they mean whatever written in the annual reports or they just sign annual reports already prepared by the supporting staff? Therefore, the present study is an attempt to find out answers to the abovementioned questions. The objective of this paper is to sensitize the managers and stakeholders towards the importance of annual reports. Reading non-useful annual reports will be a futile exercise. Thus, stakeholders should demand a quality annual report from companies (Bartlett & Chandler, 1997). Also, the managers of a company should provide quality annual reports by writing meaningful information and should not treat the publication of annual reports just a formality.

Literature Review

Various empirical and analytical researchers have found various characteristics influencing the degree of disclosures (Meek, Roberts, & Grey, 1995). Probably, Alan Robert Cerf was the first researcher who comprehensively described the factors influencing voluntary as well as mandatory

corporate disclosures. He found that the size of a corporation, listing status, debt-equity ratio, and capital structure influences the degree of disclosures in corporate reporting (Cerf, 1961). Larger corporations are often diversified and have numerous activities thus expected to disclose higher extent of information as compared to small-sized corporations (Barako, 2007). Some researchers do not find any association between the size of firms and extent of disclosures. Since disclosures are mandatory in most of the cases, hence, size of companies does not influence disclosures significantly because the nature and particulars of disclosures are determined through regulations and they are almost similar to all types of companies irrespective of their size (Raffournier, 1995). Surprisingly in some cases, small-sized companies found making more voluntary disclosures than required to attract finances and offering promising prospects to the investors (Berglof & Pajuste, 2005). Listed companies are widely-held companies having a larger shareholder base. Outside shareholders are not in a position to monitor their companies closely thus they require higher extent of disclosures from the management. Listed companies are also governed by the Securities Market Regulators apart from the primary Companies Act, and securities market regulators insist the subject companies to disclose more information in addition to the requirements of the Companies Act. Therefore, listed companies disclose more information as compared to the unlisted entities (Tian & Chen, 2007).

Companies with a high debt-equity ratio are required to disclose more information than companies with a low debt-equity ratio (Wallace & Naser, 1995). In case of a high debt-equity ratio, a company has to satisfy creditors in addition to shareholders with comprehensive disclosures in its annual reports. External creditors try to satisfy themselves on the basis of information provided in the annual reports that their claim is secured. The liquidity status of a company influences the comprehensiveness of disclosures in its annual reports (Salter, 1998). The influence of a high debt-equity ratio on the quantum of disclosure has been observed only in cases where there is a large amount of institutional financing. In case, where the debt-equity ratio is high and creditors constitute trade creditors who are not organised

financial institutions then there is no association of debt-equity ratio and comprehensiveness of disclosures in annual reports. As creditors in such cases are unable to create any compulsions upon the company because they are dispersed and do not possess contractual rights to compel companies to disclose comprehensively (Bradbury, 1992).

When a company comfortably meets its short-term financial requirements then it freely discloses all the material information in its annual reports to keep its investors assured and attracted. On the contrary, when a company is unable to meet its short-term financial requirements then it tends to conceal information to escape the negative impact of the fact that its fixed term assets are at stake. In an interesting study, researchers found that a company having a good profitability track with a high rate of returns tends to disclose more information to keep investors impressed, and consequently management attempts to get higher remuneration by comprehensively disclosing the shining prospects of the company (Singhvi & Desai, 1971). If a company is not profitable then compulsions to conceal information are two-fold. Firstly, the company cannot risk disenchantment of investors, and secondly, management wilfully misinform to protect their position and pay (Grant & Visconti, 2006). There are contrary views also. A company is under compulsion to disclose appropriate information at length in time of distress as investors, financial institutions, and regulatory bodies behave more cautious and demand full disclosures (Depoers, 2000). Some studies show that profitability and managerial preferences are interrelated in the choices of comprehensive disclosures (Einhorn & Ziv, 2008). In most of cases, management seeks to withhold information which adversely affects the reputation of the company (Kothari, Shu, & Wysocki, 2009).

A company with concentrated promoters holding discloses less amount of information. A larger number of outside shareholders need greater disclosures to know about the affairs of the company. Comprehensive detail of affairs of the company in its annual report resolves the monitoring issues and minimizes the agency cost. Thus, the capital structure of a company influences the disclosures in its annual reports (Leftwich, Watts,

& Zimmerman, 1981). The information becomes more limited in the public domain if a company is dominated by family members (Haniffa & Cooke, 2002). In line with capital structure, the presence of outside directors on the Board positively affects the comprehensiveness of the disclosures in annual reports. Outside directors especially non-executive directors closely monitor the functioning of the management and seek to disclose more information to external stakeholders (Fama & Jensen, 1983). In some cases, the presence of outside directors on the Board even independent directors has no significant impact on the comprehensiveness of disclosures in annual reports as independent directors could not muster the courage to check excessive control of the in-house directors (Gutierrez & Saaz, 2013). The big audit firms do ensure comprehensive disclosures but a continuous audit by the same firm for a longer period of time develops collusion between auditors and management consequently the quality of audit firm become irrelevant in the free flow of proper disclosures.

The above-discussed literature review reveals both relevance and irrelevance of certain factors in deciding the comprehensiveness of disclosures. The results of various studies analysed during the literature review have formulated the following assumptions to proceed further:

1. The quantum of disclosure is not static and it varies according to the profile of the company.
2. A company may have different levels of disclosures in its life, for example, if a family-owned company dilutes its holdings then more information flows in the public domain.

The existing researches have supported the development of assumptions for the present study yet these researches could not solve research questions that whether Board of directors serious takes the task of preparing annual reports and whether there is a demand from shareholder to have a quality annual report. To find out answers to these questions, I have to proceed further with the present research study.

Research Methodology

The objective of this paper is to have an insight into the relevance and irrelevance of certain factors on the comprehensiveness of disclosures in the annual reports. The study is qualitative research and

has been conducted through analysing secondary data i.e., five years annual reports of twelve listed companies. As demand and supply function of information in annual reports is also important in deciding the level of disclosure hence opinions of parties relevant to annual reports have been gathered through semi-structured interviews. These parties include five professionals from different audit firms (including secretarial audit firms), five persons on the Board of different Companies and five Stock Brokers. Since shareholders are mostly dispersed and hardly united thus stockbrokers have been considered as representatives of shareholders. The interviewees are from different background; thus, a semi-structured interview is best suitable in such cases to adopt modifications and have broad coverage of discussions (Merriam & Tisdell, 2015).

The purposive non-probabilistic sampling

method used to select the interviewees and care has been taken to have opinions of experts in their respective fields. Five stockbrokers, directors (hereinafter referred to as managers), and audit professionals are from Delhi, Mumbai, Kolkata, Hyderabad, and Bangalore. All these cities are commercial hubs and witness voluminous corporate activities. The twelve selected companies for scrutiny of annual reports were in different stages of maturity to have a diverse set of data. Out of these twelve companies, four companies are within fifteen years of incorporation and have issued initial public offerings. Four companies are having incorporated life of more than fifteen years and distributed dividends during the preceding three years. Four companies have recently faced corporate governance issues. Brief information of companies selected for scrutiny of annual reports is tabulated in Table 1.

Table 1: Brief Profile of Companies whose Annual Reports have been Analysed

Profile of Company	Maturity Level	Recent Developments
A private sector banking company	Established in the year 2004 and has a large share of market capitalization	The Reserve Bank of India placed a 30 days moratorium and suspended its Board. A new administrator has been appointed and reconstruction scheme proposed for the bank.
A private sector airline company	Established in the year 1992 and one of the leading companies in the aviation sector	The airline has suspended its operations after a severe liquidity crisis and all respective financial institutions turned down its request for funds.
A private sector non-banking finance company	Established in the year 1987 and one of the biggest financial institution	The company has defaulted payment to its lenders and consequently created panic in the market.
A housing finance company	Established in the year 1984 and one of the biggest housing finance company	Money laundering through shell companies and siphoning of funds by the promoters.
A fast-moving consumer goods marketing company and having diversified business activities through subsidiaries	Established in the year 1910 and one of the top 50 fastest-growing companies	During the last three years, the company has distributed dividend at the average rate of 650% of the face value of its shares
A mid-sized automobile manufacturing company	Established in the year 1926 and a large scale two and three-wheeler automotive manufacturing company	During the last three years, the company has distributed dividend at the average rate of 400% of the face value of its shares
A passenger and farm automobile manufacturing company	Established in the year 1945 and a large-scale automotive manufacturing company	During the last three years, the company has distributed dividend at the average rate of 220% of the face value of its shares

A multinational conglomerate having diversified business activities	Established in the year 1973 and it is among the top 500 fortune company of the world	During the last three years, the company has distributed dividend at the average rate of 70% of the face value of its shares
A government-owned natural gas processing company	Established in the year 1984 and it is the top company in natural gas production & distribution	During the last three years the company has distributed dividend at the average rate of 50% of the face value of its shares
A company manufacturing special chemicals for textile industries	Established in the year 2009 and it is a mid-sized company	The company has recently launched its initial public offering of 4.96 billion rupees
A real estate development company	Established in the year 2008 and a medium-sized enterprise	The company has recently launched its initial public offering of 69 million rupees
A real estate construction company	Established in the year 2007 and a medium-sized enterprise	The company has recently launched its initial public offering of 774 million rupees
A company engaged in grain mill and animal feed products	Established in the year 2009 and a mid-sized company	The company has recently launched its initial public offering of 4.81 billion rupees

Data Analysis

The analysis of annual reports was focused on the quality of management discussion upon the performance of the company and analysis regarding the disclosure of risk factors. The analysis is categorised in three heads poor, satisfactory, and excellent. All interviews were reduced to writing and carefully analysed after completion. The patterns of annual reports were identified and correlated with the interview discussions. An inductive concept-building process was applied for pattern matching which is used in qualitative-cum-exploratory studies (Baskarada, 2014). The interviews were non-structured, thus, soon after completion information collected through conversations was summarised and organised into a template.

Analysis of Annual Reports

All the scrutinised reports consist of pages in the range between 250 to 350 numbers of pages. Out of four companies that issued initial public offering recently, three companies have satisfactory management discussions on the performance of the company and also discussed perceived risk factors in line with their financial performance. The remaining company has poor reporting and failed to identify risk factors. Out of four companies that have a track record of dividend distribution, only one company has an excellent discussion of management

discussion on the performance of the company, the other two companies have satisfactory management discussion and the remaining company has a poor discussion on the performance of the company. All these four companies did not disclose properly on risk analysis and only reported general market conditions in their risk perception. Thus, discussion on risk factors ranked poorly in all these companies.

Out of four companies that recently faced corporate governance issues, two companies have satisfactory management discussions on the performance of the company, and the remaining two have a poor discussion. All these four companies failed to identify risk perception and provided a gloomy picture of their performance. Not a single company had mentioned any type of threat that they faced later on in coming years and eventually slipped into crisis. Thus, even though they presented a promising scenario of their performance they ranked poorly in the disclosure of risk factors.

I found repetitive information year-on-year basis in all the reports which means they lack to present ground reality and reports used as a template to just fill new financial figures along with changed scenarios that too in a very limited manner. So, I conclude that there is no serious discussion on risk identification, assessment, and a suitable plan to cope up with possible threats. Companies tend to show a

gloomy picture upon attaining properly established status and all such companies hardly discuss any negative information like non-payment to creditors, defaults in scheduled payments, and severe illiquidity, etc.

Management Perspectives on Disclosures in Annual Reports

All the managers agreed that proper disclosures are regulatory requirements and they are committed to complying with true letter and spirit. The Board of Directors is responsible for presenting annual reports to its members but executive directors hardly focus on the preparation of annual reports given their involvement of full attention to managing voluminous affairs of the company. Non-executive and independent directors have their own limitations. They meet occasionally; therefore, they rarely find the time and full information about the current working of the concerned company. Out of five managers, three managers agreed that they had taken disclosures seriously when their company needed external funding and they personally have gone through all lengthy process of writing annual reports. Except for the case of funding requirements, all managers reported to take the preparation of annual reports as routine work which has been always done by the secretarial staff. Though three respondents had personally involved in report making process yet all of them did not recall any full-length discussion of a full annual report in the Board meetings in which these reports were approved. All the managers have agreed that the Board of Directors come from different backgrounds and have excellent expertise in their respective fields but generally they have a limited understanding of all the clauses of annual reports due to different backgrounds. So, I conclude that except where management has to attract investors, the Board of Directors perceives preparation of annual reports as a routing work which has to be done by secretarial staff, and they mostly approve already prepared reports without holding any full-length discussions.

Secretarial/Auditors' Perspective on Disclosures in Annual Reports by the Companies

Out of five respondents in the professional category, three are company secretaries and two are chartered accountants. All respondents agreed that management of the company does not understand

the gravity of the seriousness of adequate disclosures in preparation of annual reports rather they take annual reports as an opportunity to promote the company. The management hardly discusses with professionals any risk-oriented critical information while preparing annual reports and keen to present already prepared reports by the supporting staff. Only financial figures and comments on audit reports get proper attention from the management. They hardly acknowledge company-specific risk perception and often relate the company's performance with the prevailing market conditions. In the opinion of professionals, the management of the start-ups (i.e., companies in their initial growing phase) discloses more information on risk perception as compared to managers of established firms. For seeking guidance, managers of start-up firms openly discuss risk factors with the professionals and supporting staff therefore this risk-related information finds a place in the annual reports. Once the company gets established the discussion on risk perception becomes irrelevant and remains only routine work. So, I conclude that companies generally reveal only information that is limited up to mandatory requirements, and except promotional-cum-compliance related activity risk-oriented disclosures annual reports are irrelevant in the case of established companies.

Stock-Brokers Perspective on Disclosures in Annual Reports

All the stockbrokers are members of reputed stock exchanges and also hold securities in various listed companies. Due to their profession, they frequently interact with all kinds of shareholders. All respondents agreed that shareholders hardly read full annual reports because these reports are too lengthy and beyond the understanding of a common shareholder. Language in annual reports consists of complex words and common shareholders are unable to interpret the technical sentences. Instead of reading annual reports, shareholders generally rely on newspaper reports and electronic media updates in making investing decisions. They have also observed herd behaviour among investors in trading securities which is absolutely contrary to cognitive decision making. Three respondents believe that shareholders only refer annual reports to verify the financial performance of a company and they do not bother at all about poor risk perception reporting in

the annual reports. Two respondents reveal that even for financial performance information shareholders rely on secondary sources other than annual reports and they also clarified that this may be due to the fact that delivery of annual reports takes time to reach shareholders while information from other sources reaches instantly. So, I conclude that disclosures in annual reports are irrelevant in the investment decision making of the shareholders and investors.

Conclusion

The findings of this study reveal that disclosures in annual reports are monotonous and repetitive in nature. The risk analysis present in the management

discussion and analysis section mostly does not conform to the financial performances. The sudden outbreak of corporate governance issues and factors responsible for such a crisis did not find any place in annual reports of concerned companies show that management tends to conceal facts and reluctant to provide material information. Except for the newly incorporated companies, the sample analysis shows that management fails to acknowledge and discuss risk factors in the annual reports. There are certain instances that prove that quality of disclosures changes with the profile and stage of maturity of companies. This behaviour has been explained with the help of the Figure 1 below.

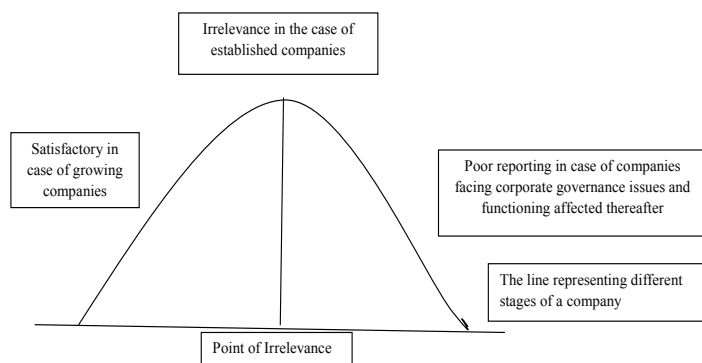


Figure 1: Behavioural pattern of risk-related disclosures in companies

The above figure displays various stages of disclosures according to the life cycle of companies. Companies, which are in the initial establishment period and searching for funding with growth prospects are more likely to have in-depth discussion on risk factors in their annual reports (Akhtaruddin, 2005). In such cases, promoters are generally novices in the corporate world and fully dependent upon professionals in regulatory compliance procedures. At the same time, they would like to attract investors and investors also seek transparent disclosures to have a smooth monitoring grip over the affairs of the company.

When the company is fully established and achieved a certain maturity level, then disclosure becomes irrelevant for both managers and investors (Cooke, 1989). In such cases, managers neither have any motivation to include in depth risk discussion in annual reports nor do they have sufficient time to personally pursue the preparation

of annual reports. Moreover, such companies are constantly generating revenues, distributing adequate dividends and stock values are also high so shareholders do not feel any need to thoroughly monitor these companies. Consequently, investors become reluctant to demand proper disclosures in annual reports. Therefore, such a phase is the point of irrelevance in respect of proper disclosures from both the sections.

When a company has serious corporate government and financial viability issues then it attempts to conceal information and pretends to present a shining scenario either due to safeguarding remuneration of managers or retaining investors' confidence (Donnelly & Mulcahy, 2008). In the case of companies that witnessed corporate governance failures, none of the companies discussed relevant risk factors in their management and discussion analysis section responsible for the crisis. Even the capital market and regulators failed to assess that in

a very short span of time these companies would run into trouble.

There are shreds of evidences which prove lack of in-depth analysis of risk factors in the annual reports and this shows the reluctance of management to do so (Farber, 2005). But such reluctance is not only due to lackadaisical attitude of management towards proper disclosure. External factors are also responsible for such poor disclosures. Certain disclosures are mandatory in nature and therefore compulsory by virtue of rules formulated by the regulatory bodies. Regulatory bodies can define headings but cannot ensure the quality of discussions. Since corporate bodies are functioning on democratic setup, thus, shareholders' activism is required to improve disclosures. In short, disclosures may be improved if demand for valuable disclosures generated from stakeholders and certainly market-based interventions can improve disclosure qualities. It has been observed that instances of corporate governance failures are always followed by a stage of irrelevance in risk factors discussion reporting in annual reports. Thus, authorities may identify such patters and timely sensitize stakeholders to take precautionary steps in preventing probable corporate governance crisis.

Acknowledgements

We are thankful to all professionals who have participated in the interview/discussion, for their valuable insights over the research topic. I express my sincere gratitude to the anonymous reviewer(s) of this paper for providing valuable inputs and comments.

Funding

The present study is not supported by any funding from any institution(s).

Disclosure of Potential Conflicts of Interest

"I declare that there is no conflict of interest."

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