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Corporate Disclosure & Investor Protection Correlation in Reduction of Equity Home Bias

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ABSTRACT

Today, the corporate world is full of malpractices and frauds happening all around the globe. The basic idea of the formation of a company and promotion of healthy commercial growth gets diluted in such situations where wrongful trading or fraudulent trading is involved. Corporate disclosure is one such important concept which helps and assists in protecting the rights of investors and shareholders of a company. The paper includes within its ambit the introduction of Corporate Disclosure in private sector along with enunciating the take of India on Corporate Disclosure. The authors through this research paper attempt to reflect the importance of corporate disclosure and investor protection which in turn helps in reduction of home bias which is quite prevalent among investors. Home bias is the preference given by the investors to domestic equities in place of investing in foreign equities in markets outside the home country. The researchers elucidate the problems associated with home bias and futher stresses upon the need for International diversification. International diversification is a major tool for reducing the home bias and plays a vital role in the growth of a country. Therefore, it can be comfortably said that there is a direct link between corporate disclosure, investor protection, portfolio investment and international diversification leading the way to reduction in equity home bias and promotion of growth. This link has been well discussed in the present research paper, establishing the need for corporate disclosure and investor protection in countries.

Keywords: *Corporate Disclosure, Portfolio Investment, Investor Protection, Home Bias, International Diversification*

I. INTRODUCTION

Corporate governance plays an important role in maintaining a balance between the Companies' Owners, the Directors and Managers of the Company. Corporate governance has developed rapidly in the past few years and is today considered really crucial in the corporate sector. Due to lack of transparency or poor governance the Asian financial market has faced

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crisis and therefore there is important need for the improvement in transparency as well as public disclosure. In the current situation of the market, key role in increasing the goodwill of a company is played by making disclosure of the corporation which provides information of the accounting system, etc. of the Company to the public in various ways.

The corporate governance compliance requirements and the mandatory or non-mandatory disclosure are regulated by the SEBI in India. Corporate disclosure plays a significant role in accomplishing the objectives of financial reporting which is making available the financial information of a corporate to the public at large. This serves in helping the public in making the right choices while investing in different portfolios therefore expanding the scope of investment as well rather than limiting it to home equities.

In general, the investors show home biasness but a comprehensive corporate disclosure reduces the investors' dilemma about investing in various companies, decreasing equity home bias towards a country. The investments should be compulsorily done on the basis of company information interpreted from the disclosure made by the companies if they make a comprehensive disclosure and work on international accounting system it will lessen the home biasness provided it is regulated by stringent and stratified securities law.

Similarly, investor protection plays a vital role in investment diversification and reduction of equity home biasness. With the sudden rise in defrauding the investors, stringent regulations in countries preventing such fraudulent acts is the need of the hour. The investors along with fair corporate disclosures by companies/firms need a just environment with less malpractices taking place related to portfolio investment. Therefore, it might not be wrong to conclude that the investors would prefer investing in portfolios where the country gives importance to good corporate governance and fair environment for investor protection which is currently being given a lot of attention in developing countries like India.

The researchers, in this paper would try to establish a close relationship between corporate disclosure and the portfolios held by the investors at the same time would highlight the key reasons behind equity home bias which is an outcome of limited corporate disclosure resulting in underweight investment in portfolios around the globe.

II. CORPORATE DISCLOSURE: OVERVIEW

(A) Intent behind introducing corporate disclosure around the world

Currently looking through the evolution of corporate disclosure in the private sector would appear similar to the present evolution of "Right to Information" issues and the ongoing debates on the same. The traces of private enterprises can be found thousand years ago which would give a clear comparison and relativity behind the introduction of modern companies and their working models like liability, disclosure, etc. In any country, the financial market and disclosures differ with changing market environment and political situations. Therefore, in developing countries financial reporting system plays a vital role in order to build a strong market economy[3]. This contemporary accounting system can be seen to originate in the 15th century where the merchants developed a system of making double entry of the records to track the business in order to provide information on economic resources, investments, creditor's obligations, transactions, etc. This was the beginning of the financial reporting and accounting system around the globe[4].

Earlier though the accounting was only done with an intention to keep a track on the transactions of the business and the final results of it but with the evolutions this intent even changed and has been constantly seeing various required changes as per the demand of situations. Today, the reporting is done to show the working standards of a company, its managing team and their capability of managing the resources of the corporation[5]. Corporate disclosure is based on suitable accounting system in order to provide accurate and true company information to its stakeholders. It has great impact on the flow of funds in the company and plays an important role in functioning of economy of the country.

(B) Stand of India on Corporate Disclosure and its application

India has been in the trading business since the early 16th century with Western Europe and then under the regime of the East India Company until Indian independence and therefore most of its system of financial accounting is adapted from the U.K. model though it has seen considerable changes after independence.

The Companies Act, India governs the disclosure of information by the companies. Its footsteps can be seen in the Indian Companies Act of 1882 itself which mentioned the requirement of balance sheets and audits of companies, etc. but that also saw considerable changes in the Companies Act, 1914. The remarkable changes were seen in the 1936 amendment of the Act which made many optional requirements compulsory in the financial reporting system though it created lot of ambiguity which led to unfair disclosures made by

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[3] Ramesh Ramanathan, *Corporate disclosures and financial statements: a brief history,* LAW MINT (Sept. 27, 2020, 10:00 PM) https://www.livemint.com/Politics/L8c4xGGYD7GkpaLjEpidHM/Corporate-disclosure-and-financial-statements-a-brief-histo.html

[4] Indian Journal of Accounting, JOURNAL OF THE INDIAN ACCOUNTING ASSOCIATION (Sept. 27, 2020, 11:00 PM) http://indianaccounting.org/img/journals/IJA-Jun-1995.pdf

[5] *Id.*

the companies[6].

After independence in 1947, India came up with its own variation of the Companies Act in the year 1956 and since then the regulations on corporate disclosure in the Act has been continuously amended as per the demands of the economy and market for the influx of funds and investors in Indian companies.

Moving forward, the Institute of Chartered Accountants, India has been the financial accounting body since long now and plays a vital role in the regulation of corporate disclosures made by the public or private companies in India. The ICAI in order to regulate the financial reporting system of companies in India issue various guidelines, accounting standards, etc. for improved accounting of companies and disclosures made in public and also created an Accounting Standard Board in the year 1977 with an agenda of harmonizing the various accounting regulations in India practiced by different Indian companies.

Another regulating body is the Securities & Exchange Board of India which was incorporated in 1988 on U.S. model of SEC and was given statutory body recognition by the government in 1992, in order to provide stringent regulation and fair environment for growth of securities market in India along with protecting the investors. Hence, SEBI also regulates the corporate disclosures to protect and safeguard the rights of investors by providing them fair and authentic company information regularly which holds great importance for growth of portfolio investment from investors around the globe, as stated in an article;

"A company is at present accountable for its performance and affairs not only to the shareholders but also to the other 'stakeholders'. In alternative terms, companies are now obliged to serve the additional informational needs of the users of the annual report, even though not mandatory under the law. Suppliers of the information (management) must make best efforts to 'disseminate' information such that the actual supply of information matches with the 'expectations' of the consumers of the information (users)."[7]

This statement clearly reinstates the vitality of corporate disclosure for providing a fair market to the investors to make a better choice while investing in portfolios gauging through the mandatory/ non-mandatory corporate disclosures made by the Indian companies.

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[6] K. Banupriya & Dr. C. Vethirajan, *Corporate Disclosure Practices in India: A study* (Sept. 26, 2020, 10:00 AM)https://www.worldwidejournals.com/indian-journal-of-applied-research-(IJAR)/recent_issues_pdf/2015/December/December_2015_1448964552__55.pdf

[7] V.K. Vasal, *Corporate Characteristics and Extended Financial Reporting-Some Indian Evidence* (Sept. 26, 2020, 10:00 AM) http://indianaccounting.org/pastresearchpapers.php

(C) Disclosure Perspective from Around the Globe

On the basis of various researches[8] conducted by scholars and researchers the fact that inevitably came up is that the foreign investments tend to make improved voluntary corporate disclosures more than the impacts of domestic investors on the disclosures made by companies. The major difference is made when the foreign investment institution belongs to a county with stringent disclosure requirements than the company's own country which leads the firm in making voluntary disclosures in order to attract those foreign investors for the influx of funds in their company. The countries with less effective disclosure and securities regulations see remarkably less foreign investors[9].

Therefore, countries around the world are taking initiatives in strengthening their laws related to corporate disclosure and securities investment. The laws relating to governance are under modifications according to the market demands as according to reliable researches internationally it is found that the investors are demanding for information related to various others factors involved in firm's diversification and growth like its opted process for nomination of directors, company's strategy, risks related to climate change, etc.[10]

III. INVESTOR PROTECTION

(A) Investor's Protection vis-à-vis Majority Control in Firms

In today's scenario, the concept of Investor Protection has become indispensable due to the increasing number of frauds and malpractices perpetually happening in the corporate world. Investor protection basically means that up to a certain extent, you get your money back in cases where the broker goes bankrupt or commits fraud. You usually tend to get investor protection, when you open a trading account at a brokerage. The amount of investor protector is defined by the limit of protection and it usually differs from country to country. In Europe, usually the amount of investor protection is around € 20, 000. In comparison to Europe, the amount of investor protection is higher in U.S., somewhat around $ 500,000. There are also some countries that do not provide investor protection at all. One of those countries is Australia. Most of the firms in these countries with poor investor protection are generally controlled by large shareholders, and so only a portion of the shares issued by firms in these particular countries can be freely traded and held by portfolio investors. It plays a crucial role how the interest of minority shareholders is protected in a firm. In the absence of such

[8] Albert Tsang, Fei Xie, and Xiangang Xin, *Foreign Institutional Investors and Corporate Voluntary Disclosure Around the World* (Sept. 26, 2020, 10:00 AM) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2363504

[9] *Ghio, Alessandro, Verona, Roberto,* THE EVOLUTION OF CORPORATE DISCLOSURE (2020).

[10] *The Corporate Governance World in 2018: A Global Review* (Sept. 27, 2020, 11:00 PM) https://corpgov.law.harvard.edu/2018/01/28/the-corporate-governance-world-in-2018-a-global-review/

protection to the minority shareholders, it leaves loose ends which are often misused by the people who have majority control in the firm to fulfill their own personal objectives. When such a situation occurs, it leads to deviation from the common objective of setting up a firm in the first place.

There are often instances when the management of a firm can take decisions which are not in favour of the shareholders but instead improves management's welfare. It can be said that the focus of the management is more on firm size rather than maximising shareholder wealth. In a lot of countries, the people who are in control of the firm are not simply taking investment choices that shareholders would prefer they did not make but they are also in control of selling corporate assets at a rate lower than market value to corporations.[11] If the right of investors are too poorly protected that those who are in control of the firm can expropriate assets, then the firms might find it too difficult and expensive to raise funds unless those in control can commit to limiting expropriation. In situations where those in control of the firm have a major stake in firm's cash flows, expropriation is costly for them when it involves deadweight costs since they end up paying a large fraction of these deadweight costs. Consequently, having a controlling shareholder with a large cash flow stake is one solution whereby firms can become public and raise public equity/funds.

According to a well-accepted model by *Shleifer and Wolfenzon,* the person responsible for setting up a firm has chances to be fined or charged in case he expropriates minority shareholders. Such a model is vital as it leads to reducing the investor risk thereby leads to better sources of finance for the firm. Therefore, it can be said that there is a direct link between investor protection and external finance received by a firm.

(B) Provisions in India backing Investor Protection

The new Companies Act of 2013 incorporated within its realms a number of provisions favouring Investor Protection and highlighting the importance of the same in ensuring good corporate governance.

The Act prohibits the acceptance of deposits from the general public and the violation of any of the provisions is a punishable offence. The section 73 of the Companies Act 2013[12] states that "*no company shall accept or review deposit under this Act from the public except in a manner recognized under Chapter V of the Act and Companies (Acceptance of Deposit) Rule*

[11] La Porta, Lopez-de-Silanes, and Shleifer (2000).
[12] The Companies Act, 2013, sec. 73.

2014[13]". The Act futher prohibits misrepresentation in prospectus of a company; the prospectus of a company is a written statement issued by the company to the general public which contains brief information regarding companies' profile and their investment proposals[14]. The section 34 of the Act provides for a criminal liability in case there is a misstatement in the prospectus issued by the company[15]. This is ensured by Section 447 of the Act which says that the prospectus issued, circulated or distributed, includes any statement, which is untrue or misleading in form or context to induce people to make an investment and shall be liable for action[16].

One such provision under the Act which provides for investor protection is section 36 of the Act[17]. According to the provision, a person cannot be fraudulently induced to invest money. It inflicts punishment on the person who intentionally or recklessly induces the investor to make the investment through any agreement for the purpose or the pretended purpose of which to secure a profit. Among the various agendas on list for every AGM, declaration of dividends is one. A dividend is the retained profit of a company which is distributed among the shareholders in proportion of the shares held by them. According to section 125 of the Act, investor's education and protection fund has to be established by the central government[18]. This fund is credited with the unpaid/unclaimed amount of application money/matured money or mature deposits. Such accumulations of the fund are to be utilized for promotion of investor's awareness and protection of investor interest. Furthermore, the section 123 of the Act says that the dividend which has to be distributed among the shareholders should be credited in investors account within five days after the dividend declaration[19].

The Act bestows a beneficial right to the investors by allowing them the right to demand financial statements of the company. This right is derived from section 136 of the Act which states that the members have the right to obtain copies of balance sheet and auditors' report of a company[20]. In the case of any default complying with this requirement, the company shall be liable for a penalty of twenty-five rupees and the authorized officer who is in default shall be liable for a penalty of five thousand rupees. Moreover, the investor has the option to

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[13] *Id.*
[14] *CGVE/U1 Topic 6 Corporate Disclosure and Investor Protection in India* (Sept. 28, 11:00 AM) https://theintactone.com/2019/03/09/cgve-u1-topic-6-corporate-disclosure-and-investor-protection-in-india/
[15] The Companies Act, 2013, sec. 34.
[16] The Companies Act, 2013, sec. 447.
[17] The Companies Act, 2013, sec. 36.
[18] The Companies Act, 2013, sec. 125.
[19] The Companies Act, 2013, sec. 123.
[20] The Companies Act, 2013, sec. 136.

proceed against the company or its authorities in a court of law under the guidelines determined under Section 436 of the Act[21].

IV. International diversification

(A) Benefits of Diversification & its role in Growth

The benefits of diversification include reduction in risk by allocating investments among various asset types, geographic regions and industries. The aim is to maximize returns by investing across different regions to reduce the chance that a market event can have a debilitating effect on an entire portfolio. When investors fail to diversify and invest beyond one's country or region, then they become too concentrated in the movements of their domestic market and economy, increasing the volatility risk level to the portfolio. When an investor is not properly globally diversified, they may miss opportunities to invest in faster-growing markets.

Furthermore, diversification benefits can be gained by investing in foreign markets since they tend to be less-closely correlated with the performance of domestic markets. For instance, an economic downturn in the U.S. economy may not negatively affect China's economy too dramatically; therefore, holding investments in Chinese equities can give investors a level of protection against losses due to a negative change in the American economy.[22]

(B) Reduction in Equity Home Bias

Home bias is basically the tendency of the investors to invest more in domestic equities, ignoring the benefits arising out of investing in different foreign equities outside the home country. The home bias was originally believed to have arisen because of the extra difficulties associated with investing in foreign equities, specifically legal restrictions and additional transaction costs. A major reason for home bias can be due to a preference in investing in domestic equities which the investor is fully aware of rather than a foreign equity of which the investor might be clueless about which can be reduced if the companies make fair corporate disclosures in the public for the investors to understand the working standards of those firms. However, the investors fail to understand how investing in foreign equities play a vital role in the growth of the firm. Investing in foreign equities tend to decrease the amount of systematic risk in a portfolio as foreign investments are less likely to be affected

[21] The Companies Act 2013, sec. 436.

[22]Mengyang Guo, *International Diversification, Excessive Growth, and Corporate Governance*, SCIENTIFIC RESEARCH (Sept. 26, 2020, 10:00 AM) https://www.scirp.org/journal/paperinformation.aspx?paperid=95619

by domestic market changes[23].

An evidentiary example of home bias can be an academic study of home bias from the late 1980s which showed that, although Sweden possessed a capitalization that only represented about one percent of the world's market value of equities, Swedish investors preferred to put their money almost exclusively into domestic equities. Similar is the case in the US too which was depicted in the 2012 research from Indiana University study titled "No Place Like Home: Familiarity in Mutual Fund Manager Portfolio Choice" which showed that some professional U.S. mutual fund managers are also likely to demonstrate the same behavioural biases in their portfolio decisions as individual investors. It also showed that the average fund tends to be overweight in stocks from its managers' home states, although the bias was seen to be stronger among managers who are less experienced[24].

Earlier, both transaction costs and unfamiliarity used to be a major barrier for the investors. But now mutual funds and exchange-traded funds (ETF) both render a relatively easy and low-cost way to diversify across International investments. Moreover, an internationally focussed financial media and the free flow of information have made owning and monitoring foreign stocks much easier.

V. CONCLUSION

The concept of Corporate Disclosure plays a significant role in the overall commercial growth of a country as it promotes fair trading in the relevant market. This also leads to promotion of healthy competition in the market which is also a prime factor in determining the corporate dimensions of a country. As we have seen, that corporate disclosure leads to lessening the instances of fraudulent trading, therefore, it can be very well said that such a practice needs to be flourished more through legislations and strict regulations. In India, the Companies Act 2013 includes within its realms a number of provisions favouring corporate disclosure. Investor protection as talked about in this research paper is also backed by a number of provisions in the Act and other regulations.

It is important to highlight the fact that a country with poor investor protection is less likely to attract foreign investments thereby leading to concentrated investors and giving rise to more home bias. Home bias is a thing which needs to be lessened for better future prospects of a country and economic growth especially the developing countries like India. The tools

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[23] Magnus Dahlquist, Lee Pinkowitz, René M. Stulz and Rohan Williamson, *Corporate Governance and the Home Bias*, CAMBRIDGE UNIVERSITY PRESS (Sept. 28, 2020, 11:00 AM) https://www.jstor.org/stable/4126765

[24] James Chen, Home Bias, Investopedia (Sept. 28, 12:00 PM) https://www.investopedia.com/terms/h/homebias.asp

for lessening the home bias can be said to be investor protection and International diversification. Diversification though might seem risky to investors but actually assists in better expected returns. These diversification benefits can be gained by investing in foreign markets since they tend to be less-closely correlated with the performance of domestic markets.

Therefore, it can be concluded that Corporate Disclosure which is the genesis of all the other beneficial factors to reduce home bias, needs to be put in practice by all the nations and even in countries that do not provide for proper legislations regarding Corporate Disclosure, needs to include these beneficial legislations in their legal regime to help the investors take fair decisions while investing in portfolios around the globe and not only in the portfolios of their home country.

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