

Disclosure and Shareholder Voting: Evidence from India

Wen He

Monash Business School
Monash University
wen.he1@monash.edu

Ankit Jain

UQ Business School
University of Queensland
a.jain@business.uq.edu.au

Shyam V. Sunder

Eller College of Management
University of Arizona
shyamvsunder@email.arizona.edu

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Abstract

The Companies Act of 2013 in India required material related party transactions (RPTs) be subject to shareholder voting and approval. RPTs are transactions between a firm and a party, either an individual or an equity-holder connected to the directors or managers of the firm. The regulators intended to protect minority shareholders from wealth expropriation through RPTs. Under the new regulation firms are required to disclose detailed information about the proposed transaction. We examine whether the *readability* and *tone* of the RPT disclosure affects shareholder voting on approval of RPTs. Readability is a property of text that captures the simplicity of language and tone captures whether information in text is being presented a biased manner. We find that while readability is not related to voting outcomes, the tone of the disclosure is positively related to both the percentage of investors voting on the resolution and the percentage of institutional investors voting in favour of the resolution. This implies that *how* the managers chose to word the RPT disclosure affects shareholder judgement on voting for the resolution. However, the tone of disclosure is not related to future profitability and the market reactions to the passed resolutions are negatively related to the tone of the disclosure. This means that broader market participants understand the managerial attempt to bias RPT related disclosures and penalize such attempts to manage the messaging. Overall, our evidence highlights the problems that regulators face in improving investor oversight through disclosure and voting. However, our results also should provide confidence to regulators that the broader market has the ability to comprehend message management on part of the managers and markets penalize managers who attempt to bias disclosure.

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1. Background and Motivation

Shareholder participation plays an important role in corporate governance, and recent studies show that granting shareholder voting power deters value-destroying corporate actions, such as equity issuance (Chen, Ke and Yang 2013), mergers and acquisitions (Becht, Polo and Rossi 2016) and related party transactions (Li 2018). Around the world, laws and regulations have made shareholder voting mandatory and binding for some important corporate decisions (Iliev et al. 2015). However, it is unclear how investors make voting decisions and what information can help them make an informed decision to support or veto a proposal. Djankov et al. (2008) suggest that mandatory shareholder approval combined with disclosure transparency can have a first-order effect in curbing agency problems and expropriating corporate decisions. In this study, we use a unique setting in India to investigate whether information disclosure on proposed related party transactions (RPTs) affects shareholders' voting, and whether retail investors and institutional investors use the information differently to make voting decisions.

Regulators have long been concerned that corporate insiders can use RPTs to tunnel firms' resources and expropriate wealth from outside investors.¹ In economies where ownership is concentrated and investor protection is weak, RPTs are more likely to present a challenge to regulators. In India regulators made all material RPTs subject to shareholder approval before they can be executed. The Companies Act of 2013 requires material related party transactions (RPTs) to be approved by disinterested shareholders. Accordingly, the Securities and exchange Board of

¹ Expropriating RPTs can take many forms, such as purchasing goods and service from related parties at prices significantly higher than those in fair transactions, granting corporate loans to controlling shareholders or executives that carry no interest or penalty for non-payment, using corporate assets as a collateral to guarantee insiders' loans from banks or other parties, leasing corporate assets to related parties at minimal cost, etc.

India (SEBI) modified the exchange listing agreement specifying that if a firm's total amount of RPTs with an individual party in a financial year is expected to exceed 10% of the firm's most recent total revenue, then the RPTs with the party will be classified as "material RPTs" and subject to voting by shareholders. The voting is restricted to only "disinterested" shareholders; who are not connected to the related party. Li (2018) shows that the mandatory shareholder voting led to a significant decrease in the volume of RPTs and 7.78% of RPT proposals failed to pass in 2014 and 2015.

In this study we examine the disclosures that are made by the management to the disinterested voting shareholders. Companies proposing to schedule a vote of approval usually disclose the information about the RPTs to shareholders through postal ballot notices or public announcements. We hand collect the postal ballot notices and announcements to examine whether the qualitative disclosure of RPTs is related to investors' voting decisions. *Ex ante*, it is unclear whether the disclosure will affect investors' voting decisions. One scenario is that because the mandatory voting deters expropriating RPTs (Li 2018), insiders will only put the legitimate RPTs to vote, and disclosure is only a sideshow to meet regulatory requirement. In this case, RPT resolutions will pass regardless of the quality of disclosure. The result in Li (2018) that 7.78% RPT resolutions are vetoed suggests that there is a variation in voting outcomes and disclosure may play a role. Alternatively, shareholders may perceive opaque disclosures as a signal of problematic RPTs. In such a case, better quality disclosures will be associated with more shareholders voting in favour of the RPT resolutions.

There is yet another possibility. Firms could intentionally use optimistic language to manage investors' expectations about the RPTs, leading to a positive association between the

tone of the disclosure and investors' support for the RPTs. However, if investors can unravel the managerial intent behind tone management, the tone of the disclosure may not relate to investors' voting decisions. However, if the tone of disclosure reflects insiders' positive information about increases in future profits and cash flows resulting from value increasing RPTs, a more positive tone of disclosure will be associated with more investor support for the RPTs.

In our final analysis, we recognize that the above discussion assumes that shareholders carefully read the information disclosure on RPTs and make voting decisions based on their reading. Prior studies show that institutional investors and retail investors differ significantly in their ability to acquire and process information. Therefore, we also examine if the impact of disclosure transparency and tone is different for institutional versus retail investors.

2. Data and Research Methodology

We hand-collect resolution related information from IIAS Adrian. IIAS is an advisory firm which examines corporate resolutions and provides voting recommendations to institutional investors. Their product, Adrian, provides detailed information on all shareholder resolutions including postal ballot notice, voting recommendation, and voting outcome. We hand-collect postal ballot notices and voting outcome from Adrian. The voting outcome details include information on total number of shares held, number of votes polled, number of votes in favour, number of votes against, separately for institutional shareholders and non-institutional (retail) shareholders.

Using textual information from disclosure on RPTs in the period from 2014 to 2018, we construct two measures of information transparency on RPTs. First, we capture the readability of the disclosure using the fog index, which is indicative of the complexity of language in the

disclosures. The second measure captures the tone of the disclosure and is calculated as the difference between the number of optimistic words and pessimistic words, scaled by the total number of words in the disclosure.

3. Results

Over the sample period, we find that the average tone of the RPT disclosure is stable, but the average fog index increases, suggesting that readability of the disclosure is worsening. On average, 44.28% of eligible shareholders cast votes on a RPT resolution,² and the participation rate is much higher for institutions (69.56%) than retail investors (21.04%) of retail investors. The evidence suggests that RPT resolutions are of significant interest to shareholders and draw significant attention from shareholders. 99% of RPT resolutions are passed, and on average, 91.43% of participating institutions vote in favour of the resolutions while 96.68% participating retail investors vote to support the resolutions.

We begin with an analysis of the association between information disclosure of RPTs and investors' participation in the voting on the RPT resolutions. The results from multivariate regressions show that the fog index is not related to the percentage of eligible investors, both institutional and retail, who cast their votes on the RPT resolution. However, we find some weak evidence that the tone of the disclosure is positively related to the participation rate by investors. The evidence seems to suggest that a more positive tone could elicit more shareholder interest in voting.

² These percentages are calculated based on the number of shares, rather than the number of investors. Relevant percentages are defined in the same way in the rest of the paper.

Examining the voting decisions, we find that the fog index is not related to the percentage of voting shareholders who vote in favour of the RPT resolutions, suggesting that the readability of RPT disclosure does not seem to affect investors' voting decisions. In contrast, we find a positive and statistically significant association between the tone of RPT disclosure and the percentage of shares voted in favour of the RPT resolutions. This positive association is driven by votes casted by institutional investors. For retail investors, the tone of disclosure is not related to their shares casted to support the resolutions. The evidence suggests that tone of disclosure has some impact on the voting decision of institutional investors and that a more positive tone is related to more support from institutional investors on the RPT resolutions. However, we don't find that the tone of the disclosure is related to the probability that the RPT resolution is passed, likely because only 1% of RPT resolutions are vetoed and thus there is little variation in voting outcomes.

We proceed to investigate whether the positive association between the tone of the disclosure and institutional investors' support of the resolution is driven by the tone management or the positive information of the managers. To differentiate these two potential explanations, we first examine whether the tone of disclosure is related to future profitability of the firms. If the positive tone reflects managers' positive information, we expect the tone to be positively related to future profitability. Alternatively, since the tone is about the proposed RPTs, RPTs with a more positive tone could reflect managers' optimistic forecasts on the positive effect of the RPTs on future performance, suggesting that future profitability could be positively related to the interaction term between RPTs and the tone. Using Return on Assets (ROA) in year $t+1$ to measure future profitability, we find neither the tone itself nor the interaction term between the

tone and RPTs are positively related to future profitability. The evidence suggests that the tone of disclosure does not seem to have any information content about future profitability.

Then we examine the market reactions to the voting outcomes of RPTs resolutions. Because vetoed RPT resolutions could be fundamentally different from passed ones, we focus on passed resolutions in the test. To provide clean evidence, we only examine the dates with only one resolution being voted. Using cumulative market-adjusted returns to measure market reactions, we find that the tone of RPT disclosure is negatively related to market reactions and this association is statistically significant at 1% level. This result is obtained after we control for the amount of RPT and a number of firm characteristics. The evidence suggests that investors do not perceive a positive tone to be a positive signal about future performance. Instead, investors seem to react more negatively to a positive tone of the RPT disclosure, implying they are able to unravel the tone management.

4. Contributions and Conclusion

The results of our study are of interest to academia, regulators, and investors. First, the study is of interest to those who are interested in knowing more about the linkage between shareholder voting and the role of managerial disclosures. While prior studies find that granting shareholder voting power deters value-destroying corporate actions and improves firm value (e.g., Chen, Ke and Yang 2013; Becht, Polo and Rossi 2016; Li 2018), we are the first to directly examine the effect of information disclosure on shareholders' voting decisions. As Djankov et al., (2008) suggest, mandatory shareholder approval must work together with disclosure transparency to be effective in constraining expropriation by controlling shareholders and corporate insiders. Our results show that information disclosure does have some effect on shareholders'

voting decisions and particularly the tone of disclosure seems to be related to more shareholders participating in the voting and voting in favour of the resolution. This result is important for regulators and shareholders, as our analysis suggests that the tone of the disclosure could be managed by corporate insiders to obtain the voting outcomes that they desire.

Second, the study has important implications for regulators who are interested in promoting better corporate governance and creating well-functioning markets where investors can invest with confidence. While many RPTs are legitimate transactions that facilitate firms' operations, corporate insiders can structure RPTs to expropriate wealth from the firm and disadvantaging minority shareholders. This is particularly a concern in emerging markets such as India where investor protection is relatively weak and controlling shareholders and promoters are dominant. In India, the 2013 Securities Act and the rule issued by SEBI empower shareholders to vote on RPTs, which deter expropriating RPTs (Li 2018). Our results show that the regulation also has some unintended effects, such as decrease in the readability of disclosure over time and tone management to influence voting outcomes. These results provide caution to regulators and investors when examining firms' RPT disclosure before voting takes place. Our study's results imply that regulators and investors should watch out for language and tone management by managers in the disclosures about the RPTs. However, the good news is that the markets more broadly are able to unravel these disclosure strategies pursued by managers.

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