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# SHAREHOLDER ENGAGEMENT AND FINANCIAL REPORTING QUALITY: INSIGHTS FROM BSE SENSEX COMPANIES

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## ABSTRACT

A qualitative financial report is accurate information of financial statements regarding firm operations, profitability, cash flows to communicate to the stakeholders. Hence, accurate financial reports are imperative for building efficient capital markets, enhancing the faithful financial reality of the companies' operations. Thus, the study has been carried out to understand the relationship of the Financial Reporting Quality, measured in terms of PMDA with Shareholder Engagement determinants and to know the impact of Shareholders' Engagement on the Financial Reporting Quality of the BSE-SENSEX companies and found that PMDA has a positive relationship with Leverage, Firm size, and Industrial effect whereas, negatively related to CEO Duality. Furthermore, the results of the t-test indicate that there is a significant positive impact of financial reporting quality on shareholder engagement (SEQ), along with determinants such as SEAGM, F_SIZE, and industry effect variables. In contrast, the quality of financial reporting is negatively impacted by SEVOT, SEED, SENED, and SEBMEET.

**Keywords:** Shareholder Engagement Quality; Voting; AGM; Executive Directors; Board Meetings; Financial Reporting; **P**erformance **M**atched **D**iscretionary **A**ccruals.

**JEL: F65, G30, G32, G34, M41, O16**

## 1. INTRODUCTION

A company's success and net value are depicted in its financial reports. Fairly depicted financial statements attain the stakeholders' trust which enables the organization to function smoothly and enhance the confidence among the investors. Hence, the objective of any company is to protect the policies of the Companies Act, of 2013 relating to financial statements, maintaining corporate integrity and preserving the interests of the shareholders. Moreover, the availability of high-quality financial reports provides positive information for financial suppliers and other stakeholders for making decisions regarding funding, allocation, and utilization of resources.

The **F**inancial **R**eporting **Q**uality **(FRQ)** concept is broad and depends upon the objectives of the study conducted. Kimmel et al. (2020)[1] defined the quality of Financial Reporting as the veracity of the annual accounting statements in communicating information about the company's predicted cash flows which helps in making investors in making decisions. Further, Penman (2002)[2] defined it as a degree of reality in reflection of earnings reported. Certainly, it is all about how well the financial statements reverberate the company's legitimate economic outlook (Watkins, 2004)[3].

Financial Reporting Quality encompasses substantial financial and non-financial data that empowers investors to make informed judgements. When owners become involved in the administration, they gather, organize, and reveal more reliable data. Consequently, Shareholders' engagement elevates the standard of the company's reports. Furthermore, this involvement serves as a safeguard against fraudulent activities and misrepresentations within the company's financial statements.

**S**hareholders **E**ngagement **Q**uality **(SEQ)** enhances firm performance, picturizes fair reports and contrastingly it may also decrease the firm performance by providing possibilities for shareholders cum directors to become prey to the managerial opportunistic behavior which boosts the stock price and improves only short-term performance (Rose et al. 2013)[4]. Equivalently, risk aversion of shareholders makes them accept low-return investment strategies. However, these two cases result in biased financial reporting. To enhance the better insights on this relationship, this paper focused on how Shareholder Engagement impacts the financial reporting quality of BSE (Bombay Stock Exchange) SENSEX companies.

## 2. DETERMINANTS OF SHAREHOLDER ENGAGEMENT QUALITY

Before establishing the relationship between Shareholder Engagement and Financial Reporting Quality, it is imperative to possess a comprehensive understanding of the determinants of Shareholder Engagement specific to the Indian context. The following list enumerates the appropriate determinants of Shareholder Engagement Quality that have been considered for this study:

***Percentage of Voting:*** It is an important determinant of Shareholders Engagement Quality as abnormal accruals are lower in the firms where shareholders' voting percentage is high regarding auditors' selection (Dao, 2012)[5]. Hence, the opinions of shareholders are considered for this study to measure the influence of Shareholder Engagement on Quality of Financial Reporting.

***Attendance at Annual General Meeting:*** Shareholders are implacable in the thrust of better disclosure and transparency, and they make use of Annual General Meetings (AGM) for exhibiting and communicating their concerns. As per the UK provisions, Audit remuneration committees and Nomination committees must attend the AGM, whereas in Singapore, auditors attend the AGM to solve the queries of shareholders for translucent practices on reports. Hence, it is considered imperative for shareholders as it is a great opportunity to seek clarifications from the directors and thereby heed meaningful and transparent explanations for queries raised by the shareholders. Thus, it is essential in forming the equation.

***Percentage of Shareholders as Executive Directors*:** Shareholders as directors concentrate more on monitoring the management Kao (2014)[6] and increasing the firm value (Hashim, 2008)[7]. Contradicting, Pergola (2011)[8] found a higher number of directors supporting the management of earnings; it might be due to the lack of fear of removal. Hence, to understand Shareholder Engagement Quality's impact on reporting quality, this term is included in the equation.

***Percentage of Shareholders as Non-Executive Directors:*** The directors' board is treated as the central point to provide an effective oversight regarding the financial reporting system for its owners (Mansor, 2013)[9] and that non-executive directors are more controlling than others (Abubakar 2019)[10]. Whereas He et al. (2009)[11] opined that outside directors may enhance Financial Reporting Quality more than inside directors. As non-executive directors play an influencing role, this variable is added to analyze the influencing role of Shareholder Engagement on the Quality of Financial Reporting.

***Attendance at Board Meetings*:** Wang (2010)[12] opined that the quality of financial statements was influenced by the role of the board of directors in improving a company's performance. Hence, this term is considered for framing the equation.

**Control Variables:** A few more determinants of the equation used as control variables such as Board size, Board Independence, Firm age, CEO Duality, Firm Size, Firm Performance, Leverage, Industrial effect, and Year effects to study the relationship of Shareholder Engagement Quality with the Financial Reporting Quality metrics, reviewed by academicians and researchers, are presented below:

***Board Size*:** The board size is used as a control variable and found to have a negative relationship by Alzoubi (2014)[13]. Whereas studies by Larcker (2007)[14], Gana (2011)[15], Akeju (2017)[16] showed a positive significant impact on reporting quality. Thus, it is included in the equation to know its impact.

***Board Independence*:** Klien (2002)[17] states that more independent directors in the board helps in better monitoring and preventing earnings management (Beasley, 1996)[18] which minimizes opportunistic behavior and therefore improves Financial Reporting Quality. Hence, added to the equation to analyze the impact is this study.

***Firm Age*:** Abubakar (2019)[19] found an inverse relationship of Age with the Quality of Financial Reporting. So, included here in framing the equation to measure the Shareholder Engagement's impact on the Quality of Financial Reporting.

***CEO Duality*:** The previous studies of Davidson III et al. (2004)[20] revealed that organizations with a dual CEO are more likely to control earnings because the management can influence the decision-making process to suit their interests, hence, it is considered to evaluate the shareholders' Engagement impact on the quality of Financial Reporting.

***Size of the Firm*:** Beest et al. (2009)[21] choose the firm's size as a control variable to understand the quality of reporting by calculating the natural log of the total assets (Athanasakou, 2012)[22] and found a positive relationship with reporting quality. Smaller firms have a higher tendency in manipulating their earnings due to less scrutiny (Li 2006)[23]. Whereas larger firms are less involved in earnings management through discretionary accruals as they bear high administrative costs (Shaikh et al, 2019)[24] and this might be the result of effective control and governance mechanism besides the qualified auditors. Thus, it is imperative to add to the equation.

***Firm Performance*:** Earnings are managed to meet the stakeholders' expectations regarding the firm's performance. Hence it has a significant role in influencing the quality of financial reports. Studies by Farrer (1998)[25]; Graham, et al. (2005)[26] used **EPS** (**E**arnings **P**er **S**hare) as a yardstick of firm performance while studying the impact on Financial Reporting Quality. Hence, inevitable in adding to the equation.

***Quit Leverage*:** Athanasakou (2012)[27] measured Leverage as a ratio by dividing liabilities by total assets. It is added as a control variable by Graham et al. (2005)[28]; as it influences the management decision on earnings management. Hence, included in analyzing the objective of the study.

*Industrial Effect*: Beest et al. (2009)[29] suggested that Industrial effect can be used as a variable to measure the Financial Reporting's quality. Thus, included in the equation.

***Year Effect*:** The year fixed effect explains the differences in the presentation of financial statements which are not explained by the other variables over time due to the modification of accounting standards and rules by regulators over the period (Leuz et al. 2003[30]) and adoption of new accounting policies by the Company. Hence, it is inevitable to include the term in the equation.

## 3. REVIEW OF LITERATURE

Upon thorough analysis of the determinants pertaining to Shareholder Engagement Quality, a detailed examination of existing literature was conducted to identify any research gaps and establish the necessity of this study.

ACCA Global (2016)[31] described that shareholders appointed to the board of directors serve as agents in protecting the stockholder's interest to look over the regular activities of the business. Additionally, their interference in management reduces aggressive financial reporting practices by the managers (McConvill et al. 2004)[32]. Moreover, Shareholders' involvement as directors has a positive impact on agency cost reduction theory and leads to better performance (Bhagat, 2013)[33] and mitigated agency cost maximizes the firm value (Jensen, 1976)[34]. Besides that, Farrer (1998)[35] found that ownership for directors motivates them to make firms perform well by protecting shareholders' interest as they promote their own interest and curb management opportunistic behavior to manipulate firm accounting earnings and resulting in higher Financial Reporting Quality (Leuz et al. 2003)[36]. Hapsoro (2020)[37] also concluded that shareholders' ownership decreases the Discretionary accruals and brings a positive impact on FRQ and promotes decision-making.

Maglike et al. (2009)[38] opined that directors' ownership and board independence may raise the chances of opportunistic behavior by the management. The works of Hassan (2015)[39] proved that reporting quality is positively associated with shareholder wealth maximization. Moreover, Cho et al. (2015)[40]; Patro (2016)[41] found a negative association while Armstrong (2016)[42], and Taouab et al. (2014)[43] concluded a mixed relationship, unlike Da Paixao (2015)[44], who declared it as insignificant in reporting quality. However, the studies of Farrer (1998)[45] stated that owners as directors up to 5% of the ownership increase the performance of the firm but if ownership extends above 5% gives negative returns and it is also supported by McConnell (1990)[46] and Athanasakou (2012)[47].

Based on the preceding concise overview of previous research, it is evident that previous studies investigated the correlation between Shareholders' Engagement and Financial Reporting Quality with different determinants and metrics, conducted over various time frames and in different settings. Consequently, the present study is undertaken with the objective of scrutinizing the relationship between Shareholder Engagement and Financial Reporting Quality within the specific context of India. Additionally, the study seeks to analyze the influence of Shareholder Engagement on Financial Reporting Quality by jointly considering select determinants. The following objectives will guide this research endeavor:

## 4. OBJECTIVES OF THE STUDY

***i)*** *To apprehend the relationship between Shareholder Engagement and Financial Reporting Quality,*

***ii)*** *To analyze the impact of Shareholder Engagement on Financial Reporting Quality.*

The above objectives are carried out with the help of the following research methodology.

## 5. RESEARCH METHODOLOGY

**5.1 Scope of the study:** Earnings are managed by overstating or understating. Overstating of accruals is to window dress the firms to have a better picture of the firm and raise the prices and issues of shares, whereas understating is to cut down the regulatory cost (Shaikh et al. 2019)[48]. Hence, Discretionary accruals are used as a metric to assess earnings management suggested by Xie et al, (2003)[49] and Jaggi (2007)[50]. Thus, **PMDA (P**erformance **M**atched **D**iscretionary **A**ccruals) is viewed as a measure of the quality of financial reporting. Additionally, Return on Assets is included in the measurement of discretionary accruals to fit in a regression approach which is called as modified Jones model, a superior measurement of Financial Reporting Quality. The PMDA model is further extended by the addition of determinants of Shareholder Engagement to test the objective to study the relationship of Shareholder Engagement with the Quality of Financial Reporting.

**5.2 Period and Sample of the Study:** The evolution of the Companies Act of 2013 made a huge impact on the corporate world in our country. It enlarged the number of shareholders and the quality of shareholders' involvement in all business affairs. So, this study dealt with Shareholder Engagement after the Companies Act for a period of 5 years. The sample of the study is confined to **BSE** (**B**ombay **S**tock **E**xchange) **SENSEX** companies as they represent most of the sectors and most traded companies. The number of BSE SENSEX companies considered for the study is 31 and the number of years for which the data of 31 select companies considered is 5, hence the total number of observations (N) is 155 (31 Companies x 5 years).

**5.3 Source of the study:** The data of the select determinants or terms in the equations applied for the study are extracted from the annual financial reports of the select firms' statements, and websites of the select companies.

**5.4 Tools of the study:** The study uses Pearson's Correlation Coefficient, Regression Analysis, ANOVA (**AN**alysis **O**f **VA**riance) to determine the relationship. **S**tatistical **P**ackage called SPSS, is used to analyze the data to derive relevant analytical measures.

**Hypotheses:**
The relationship between Shareholder Engagement and Financial Reporting Quality is examined by using the following hypotheses*:*

**$H_{O4a}$:** *There is no significant **relationship** between Shareholder Engagement Quality and Financial Reporting Quality.*

**$H_{O4b}$:** *There is no significant **impact** of Shareholder Engagement Quality on Financial Reporting Quality.*

**Equation***:* To test the above hypothesis set in consonance with the study objectives, a model called **P**erformance-**M**atched Jones Modified Model **(ABS_PMDA**), is expanded by adding the determinants of Shareholder Engagement and analyzed with the help of multiple regression model. The equation and the notation of the terms are given below:

$$\mathbf{ABS\_PMDA=\beta_0+\beta_1SEVOT+\beta_3SEAGM+\beta_4SEED+\beta_5SENED+\beta_5SEBMEET+\beta_6BODIND+\beta_7BODSIZE+\beta_8CEODUALITY+\beta_9F\_SIZE+\beta_{10}LEV+\beta_{11}FIRMPERF+\beta_{12}Industry_{it}+\beta_{13}YEAR_{it}+\varepsilon_{it}}$$

**Notation:**

**ABS_PMDA (P**erformance **M**atched **D**iscretionary **A**ccruals) is a metric of Quality of Financial Reporting measured as absolute value, and a reconstructed model of Kothari-Jones is presented hereunder as,

$$\mathbf{PMDA = TA_{i,t}/A_{it-1} - NDA_{i,t}/A_{it-1}}$$

*Here,*

**$TA_{i,t}/A_{it-1}$** is measured by using the revised Jones model as,

$$\mathbf{TA_{i,t}/A_{it-1}=\alpha_i[1/A_{it-1}]+\beta_{1i}[\Delta REV_{it}-\Delta REC_{it}/A_{it-1}]+\beta_{2i}[PPE_{it}/A_{it-1}]+\varepsilon_{it}}$$

*Where,*

**$TA_{i,t}$ - T**otal **A**ccruals in **'t'** year for **'i'** firm (determined by operating profit after tax – cash flow from operations);

**$A_{it-1}$ -** Total **A**ssets in year '**t-1'** for firm '**i'**;

**$\Delta REV_{it}$ - REV**enues in **'t'** year less revenue in year **'t-1**' for firm **'i'**;

**$\Delta REC_{it}$** - Net **REC**eivables in **'t'** year less net receivables in year **'t-1'** for **'i'** firm;

**$PPE_{it}$ -** Gross value **P**roperty, **P**lant and **E**quipment in year **'t'** for firm **'i'**;

**$\varepsilon_{i,t}$ - E**rror in **'t'** year for firm **'i'**.

*And,*

$$\mathbf{NDA/A_{it-1} =\alpha i[1/A_{it-1}]+\beta_1[\Delta REV_{it}-\Delta REC_{it}/A_{it-1}]+\beta_2[PPE_{it}/A_{it-1}]+ \beta_3ROA+\varepsilon_{it}}$$

*Here,*

**ROA (R**eturn **O**n **A**ssets**)** is Net Income divided by Assets*100.

*And,*

**SEVOT** (**S**hareholder **E**ngagement through **VOT**ing) is the percentage of voting in the annual general meetings.

**SEAGM** (**S**hareholder **E**ngagement through Participation in **A**nnual **G**eneral **M**eeting) is the percentage of shareholders who attended the Annual General Meetings.

**SEED** (**S**hareholder **E**ngagement through Shareholders as **E**xecutive **D**irectors) is the proportion of shareholders appointed as executive directors.

**SENED** (**S**hareholder **E**ngagement through Shareholders as **N**on-**E**xecutive **D**irectors) is the proportion of shareholders non-executive directors in the board of the company.

**SEBMEET** (**S**hareholders **E**ngagement through participation in **B**oard **MEET**ings) is the attendance percentage of directors in the board meetings.

**BODIND** is the **BO**ar**D IND**ependency is the Percentage of Independent Directors on the Board.

**BODSIZE** is **BO**ar**D SIZE** is the number of board directors.

**CEO DUALITY** is the Percentage of directors acting as both **CEO** and **Chairman.**

**F_SIZE** - **F**irm **SIZE** is the **N**atural **L**og of **T**otal **A**ssets.

**LEV** - **LEV**erage of the firm.

**FIRMPERF** - **FIRM PERF**ormance measured by Earnings Per Share.

**Industry effect -** It is the dummy variable taken as 1 for companies in the banking sector and 0 for other than banking sectors.

**Year Effect -** It is the dummy variable taken as 1 in the year in which accounting policies are changed.

**β** - **R**egression **C**oefficient or Slope.

$\boldsymbol{\varepsilon_{it}}$ - an **E**rror in **'t'** year for firm **'i'**.

## 6. SHAREHOLDER ENGAGEMENT AND FINANCIAL REPORTING QUALITY

**6.1 Nature:** The following table 1 explains the nature in terms of the Mean and Standard deviation of Shareholder Engagement and Financial Reporting Quality at the BSE SENSEX companies considered for the study.

From **table I** it is indicated that the provisions of the Companies Act, 2013 are strictly adhered to by the firms under the study. Specifically, it is observed that all companies are in compliance with Sec 149(9) concerning the appointment of independent directors, and there is minimal variance in the size of their Boards. The companies included in the sample exhibit similarity in managing accruals, likely due to their proximity in size. Additionally, the industrial effect shows a low level of deviation. Nonetheless, certain variables, namely Year effect, CEO Duality, Firm Performance, and leverage, exhibit significant variation among the BSE SENSEX companies included in the study during the selected period.

After analyzing the qualities of Financial Reporting Quality and their influencing terms in preceding paragraphs, an effort is made here to evaluate the relationship with former and the latter.

**6.2 Relationship:** The table II may explain the relationship of Financial Reporting Quality in terms of PMDA and Shareholder Engagement at the BSE SENSEX companies considered for the study and the following conclusions may be drawn as follows:

**i)** The positive relationship between Leverage and PMDA shows that firms with a higher proportion of debt are not much focused on managing their earnings. Because the earnings are manipulated to attract a higher number of equity shareholders by highly equity-oriented companies. But, when firms are employing more debt than equity, managing earnings may be minimized which may lead to good Financial Reporting Quality.

**ii)** The positive relationship between Firm's size and PMDA explains that the selected firms with abundant assets have been transparent regarding their financial reports. This may be due to the likelihood of legal compliance or maybe the firms might have optimal utilization of the assets. Hence, the question of manipulating the accruals is not arising, which implies that companies of larger size have more qualified auditors, who obey earnings management and represent a good quality of Financial Reporting which is proved in the studies of Swastika (2013)[51].

**iii)** The negative relationship between PMDA and CEO Duality indicates that Discretionary accruals increase when the board's chairman is occupied by the firm's CEO. Since the probability of manipulating the reports and displacing the frauds or mismanagement of resources may be high. To cover up the inability, the dual role of the CEO manages the firms' earnings. The study of Mansor (2013)[52] proved that the reporting quality diminishes when dual roles are played by a person due to a lack of transparency.

**iv)** A positive relationship between PMDA and the Industrial effect may reveal that Discretionary accruals are the most prevailing activity in companies other than banks. Legislation and transparency are high in banks where the scope of manipulating earnings is low. Hence, the study may conclude that banks have maintained better Financial Reporting Quality compared to other sectors based on the sample taken.

To sum up, the banks in the sample consist of more shareholders as non-executive directors, and companies with CEO Duality also have a good proportion of shareholders as non-executive directors. Leverage is more in banks, and it is positively related to Firm's Size, and PMDA but is negatively associated with the performance of the select firms (Earnings Per Share). The size of the company (assets) is huge for banks compared to other sectors and the Size has a negative relationship with the Year effect whereas, positively related to Discretionary accruals. CEO Duality is prevailing in sectors other than banks and is positively associated with attendance at board meetings whereas, negatively related to discretionary accruals. Attendance at board meetings and Board size is positively related to PMDA and managing accruals is high in sectors other than banking. In brief, PMDA has a positive relationship with Leverage, Firm size and Industrial effect whereas, negatively related to CEO Duality.

### 6.3 Influence:

After analyzing the nature and relationship among Shareholder Engagement determinants with Financial Reporting Quality, the study is further strived to test the significance of the relationship by ANOVA and the results of the analysis are presented in below table 3 & 4:

**Table III** may reveal that t-test results whose p-value is 0.00 for all variables, which means there is no difference in the mean values of Shareholder Engagement determinants and Financial Reporting Quality. Thus, it rejects the null hypothesis and proves that the alternative hypothesis is accepted. It may be concluded that there is a significant relationship between Shareholder Engagement and Financial Reporting Quality in the select companies. Hence, it may be advised that companies promote better shareholder engagement to ensure fair financial reporting practices.

**Table IV** may reveal that the significant values of the t-test for Constant, Percentage of Voting (SEVOT), Attendance at Annual General Meeting (SEAGM), Percentage of Shareholders as an Executive (SEED) and Non-Executive Directors (SENED), and Attendance at a Board Meeting (SEBMEET), overall Shareholder Engagement Quality, Firm Size, Industrial effect determinants, the significant value are less than 0.05 which implies rejection of null hypothesis and acceptance of alternative hypothesis, concluding that there is a significant positive impact of SEAGM, SEQ, F_SIZE, INDUSTRY EFFECT variables on Financial Reporting Quality whereas, SEVOT, SEED, SENED, SEBMEET have a negative influence on the Quality of Financial Reporting.

## 7. CONCLUSIONS

It may be concluded that BODIND, B_SIZE, F_SIZE, and PMDA are with low variation, and CEO Duality, Firm performance (EPS), Lev, Industry Effect, and Year Effect are with high variation. PMDA has an insignificant positive relationship with all the SEQ determinants except SEVOT which has an insignificant negative relationship. Whereas a positive significant relationship with Leverage, Firm size, and Industry Effect has a significant negative relationship with CEO Duality. Though SEQ determinants do not have any significant relationships, they have shown an impact significantly on the Quality of Financial Reporting. Further, the determinants such as SEAGM, SEQ, Size and Industry Effect (Sectoral Effect) have significant positive impact. While SEVOT, SEED, SENED, SEBMEET have a significant negative impact on the Quality of Financial Reporting.

It may be deduced that to improve Financial Reporting Quality, Shareholder Engagement must be enhanced by complying with the rights provided in the Companies Act, of 2013. Apart from that, family members' ownership should be regulated, and transparency must also be increased in sectors other than banks, especially where CEOs perform dual roles to control the opportunistic behavior of the CEOs. Other than the factors explained in the study, quality auditor, and outsourced internal audit functions are significant in apprehending the level of earnings management in the firm as the same was found by Mansor (2013)[53].

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