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CORPORATE GOVERNANCE AND FIRM PERFORMANCE-EVIDENCE FROM INDIAN STOCK MARKET

A. K. S. Sukumaran*

Abstract: The earlier studies made to find the relationship between corporate governance and firm performance are divided on the questions relating to whether good corporate governance practices are helpful to improve the value of the firm and this has prompted the author to make this study to search for evidence from the Indian stock market.

Two important factors included in the modern corporate governance model are, the size of insider ownership and the role independent directors of the Board, as these two factors have important implications in the fulfillment of the objectives of good corporate governance. Jamie Allen (2010) states that board independence has received much of the attention as an idea of corporate governance.

The contribution of this study to the existing literature is selecting a near homogeneous sample of firms for the analysis and the inclusion of Market Capitalization Sales ratio as an additional market based performance measure and Cash Profit Margin as one of the control variables to find whether any conclusive evidence could be found in the study of the relationship between firm performance and corporate governance.

The findings of the study prove that the management and market dynamics of the Indian firms are different from those of the West. More number of independent directors and diffused ownership seem to be doing no good for the market values of the Indian companies.

Keywords: Corporate Governance, Firm Performance, Independent Directors, Promoters' Shareholding

INTRODUCTION

Many studies have been made to understand the nature of the relationship between corporate governance and firm performance and valuation. These studies are divided on the questions relating to whether good corporate governance practices are helpful to improve the value of the firm and this has prompted the author to make this study to search for evidence from the Indian stock market.

The recent scandals in the corporate sector in India, US and the European countries have proved that bad corporate governance has destroyed the wealth of many companies and economies. While it is accepted that good corporate governance is key for the long term growth and sustenance of firms, the studies thus far made could not find definitive evidence for the positive contribution of good corporate governance (Alka Banerjee *et al.*, 2010).

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* Professor, School of Management, SASTRA University, Thanjavur, India

Corporate Governance is about maximizing the shareholder value in a corporation. Corporate Governance is concerned with the owners and managers operating as trustees for large or small shareholders (Alka Banerjee *et al.*, 2010). Bain and Band (1996) and, Bhagat and Jefferies (2002) believe that the pillars of corporate governance are dispersed ownership, independent board of directors, equal rights of minority shareholders, timely and transparent information system and independent auditor and these factors have a positive relationship with the value of a firm. Also, transparency, accountability, disclosure and protection of the shareholder rights are the corner stones of corporate governance.

Corporate governance aims at maximization of shareholders' wealth, not compromising the interests of the stakeholders and the responsibilities of the firm as an organ of the society. Corporate governance can mean the protection of shareholders' money at the lowest level to the efficient utilization of the society's resources for the welfare of the society. OECD Principles of corporate governance (2004) and other corporate governance indexes concentrate on the many characteristics of corporate governance principles and not in measuring the effect of such principles on performance based on the assumption that sound principles would take care of the results themselves.

RESEARCH PROBLEM

The context of this study is set by the argument of Jensen and Meckling (1976). According to Jensen (1986) and Jensen and Meckling (1976) agency cost arose because of the misalignment between the interest of the ownership and management and inefficient outcomes could be avoided by having outside directors in the board. The goal of a firm in using governance is to alleviate the agency conflicts among the various stakeholders and enhance the overall performance. The primary agency issue in the Indian context is the conflict between the promoters and the minority shareholders unlike the Anglo-Saxon model of agency problem where the conflict is between the management and the interest of the shareholders (Mukherjee, 2004). The differences in cultural and management styles in the Asian countries has been widely reported. Subrata Sarkar (2010), stated that it is all the more important in the Asian and Indian context to have an independent board where the business groups owned by families control firms. (Jayati Sarkar, 2010) stated that the nature of agency problem is essentially different from that present in the diffused ownership structures. According to Jayati Sarkar (2010), around 72% of the total assets in India was dominated by listed group affiliates, and only two of the top 20 listed non-financial companies were standalones. According to Dutta (1997), about 99.9% of all private Indian companies are owned by family firms.

Two important factors included in the modern corporate governance model are, the size of insider ownership and the role independent directors of the Board, as these two factors have important implications in the fulfillment of the objectives

of good corporate governance. Jamie Allen (2010) states that board independence has received much of the attention as an idea of corporate governance. In India, besides the SEBI dictated decade old provisions of Clause 49 in the Listing Agreement, the recently introduced Companies Bill, 2012 also emphasizes the key role of independent directors in the boards. K. P. Krishnan *et al.*, (2010), after analyzing the experiences faced in the implementation of corporate governance practices, expressed that increasing the public shareholding would prove to be more effective.

Most studies prefer market based measures to ascertain the value creation of a firm than accounts based measures. The value of the firm has been captured in most of the previous studies based on Tobin's Q and its surrogate, Price Book Value ratio (PBV). The other control variables considered along with corporate governance were firm size, sales, age of the firm, debt equity, CEO Duality, board size etc.

The author believes that for the purpose of studying the relationship between firm performance and corporate governance, it is necessary to identify a set of firms having near uniform characteristics, as the metrics of market performance and valuation measurements differ among the various categories of firms. The contribution of this study to the existing literature is selecting a near homogeneous sample of firms for the analysis and the inclusion of Market Capitalization Sales ratio as an additional market based performance measure and Cash Profit Margin as one of the control variables to find whether any conclusive evidence could be found in the study of the relationship between firm performance and corporate governance. The author would like to emphasize that it is essential that such relationships are studied for homogeneous firms, not across all the firms in the stock markets and countries as the heterogeneous nature of firms can distort the underlying relationship.

Number of independent directors and the size of the promoters' shareholding are taken in this study as the variables of importance to represent the corporate governance. The control variables chosen are Return on Capital Employed and the Cash Profit Margin. The value side of the firm is measured through Market to Book Value, which is similar to Price Book Value ratio, a surrogate accepted for Tobin's Q. Also, Market Capitalization Sales ratio has been used in the other model to measure the market value creation. The author considers Return on Capital Employed as a better control variable than most other variables used in the earlier studies because of the absence of ambiguity in finding the value of the capital employed and the meaning of returns. Again Cash Profit Margin is not affected by different methods of depreciation policies, simple to understand, and the stock market analysts consider it as an important dimension in the valuation of the firm.

REVIEW OF LITERATURE

Better corporate governance leads to better performance (Brown and Caylor, 2006; Durnev & Kim, 2005; Peng, 2004). Alka Banerjee, Subir Gokarn, Manoranjan

Pattanayak, and Sunil Sinha (2010) made a study considering the governance scores obtained from S & P ESG India Index and found that the firms having higher Index gave better returns. Gillette *et al.* (2003) show that inefficient outcomes in agency costs can be prevented by having outside directors. Independent directors in the Board can be considered as proxy for good corporate governance (Alka Banerjee *et al.*, 2010). Baysinger and Butler (1985), and Rosenstein and Wyatt (1990) found that the firms are rewarded for the appointment of independent directors. According to Fosberg (1989) the proportion of independent directors has no relation with various firm level performance measures. Hermalin and Weishback (1991) and Bhagat and Black (2000) measured the value of the firm using Tobin's Q and found that the proportion of independent directors did not have link with the value of the firm.

Accounting variations do not affect market based measures and these market based measures reflect the firm's future prospects better (Alka Banerjee *et al.*, 2010). There is non-linear relationship between insider ownership and performance and the relative strength of the alignment effect vis-à-vis the entrenchment effect, changing with the change in the ownership (Jayati Sarkar, 2010). Higher debt equity ratios were noticed for major ownership category of firms when compared with the firms in the minor ownership category (B. V. Pani *et al.*). According to Yermack (1996), greater firm value is associated with smaller boards. Agarwal and Knoeber (1999) have found negative effect on firm performance because of the outsiders in the board. A number of studies in developed countries have reported that positive results were achieved due to the higher proportion of independence directors in the Board (Beasley, 1996, Dechow *et al.*, 1996; Peasnell *et al.*, 2000; Kleinz, 2002; Davidson *et al.*, 2005). Hafiza Aishah and Devi (2004) found no support for board independence on the quality of earnings. Zubaidah (2009) argued that the opportunistic attitude of the mangers can be controlled with the presence of non-executive directors in the board. Dahya and McConnel (2003) and Dehane et al., (2001) found a significant positive relationship between the ratio of independent directors and return on equity among Belgian companies. Yermack, (1996) and Eisenberg *et al.*, (1998) have recorded that board size has negative relationship with firm performance. Some studies such as Schellenger *et al.* (1980), Daily and Dalton (1992), Tian and Lau (2001), and Luan and Tang (2007) found that more outside independent directors in the Board improved the firm's economic performance. Baysinger and Butler (1985), Chaganti *et al.* (1985), Rechner and Dalton (1986), Zahra and Stanton (1988), Fosberg (1989), Hermalin and Weisbach (1991), Barnhart *et al.* (1994), Grace *et al.* (1995), Barnhart and Rosentein (1998), Dalton *et al.* (1998), Dalton and Daily (1999), Davidson III and Rowe (2004), Fernandes (2005) and Cho and Kim (2007) could not find any relationship between the number of outside independent directors and firm performance. Renato Giovannini, found that independent advisors did not positively affect performance and specifically for family firms outside directors were not the best way to improve performance. Rashid *et al.* (2010), could not find direct relationship between market values , board

independence and board size for S&P 500 Index. The findings of Ahmandu Sanda *et al.* (2005) do not support that the firm performance was helped by the presence of outside directors. Brown and Caylor in corporate governance and Firm's Performance (2004) relate "Gov-Score" to operating performance, valuation, and cash payments for 2347 firms in the United States and show that poorly governed firms have lower operating performance, lower valuations and pay out less cash to their shareholders when compared with better governed firms. These studies, by and large, find positive relationship between firm performance and the presence of the independent directors and diffused ownership in the US and other developed countries and negative relationship among firms in the developing countries.

INDEPENDENT DIRECTORS AND PROMOTERS' SHAREHOLDING REQUIREMENTS IN INDIA

Clause 49 of the Listing Agreement of the National Stock Exchange of India states the mandatory requirements for listed companies in India. The Bombay Stock Exchange also stipulates these requirements to the companies in the Listing Agreement. As per this Clause, the non-executive directors shall constitute not less than fifty per cent of the Board of directors of all listed companies. Where the Board is chaired by a non-executive director, the independent directors shall be not less than one-third of the strength of the Board and where such chairman is an executive director, the Board shall consist of at least fifty per cent independent directors. It is also provided that where the non-executive director who chairs Board Meetings is the promoter or a relative of the promoter, then the independent directors shall constitute at least fifty per cent of the Board. It is stipulated that where an independent director resigns or is removed from office, the vacancy shall be filled within 180 days by appointing another independent director.

An Audit Committee is one of the most important Committees in the design of corporate governance, having wide powers for enforcing financial discipline and good corporate management practices. Independent Directors shall constitute at least two thirds of the strength of the Audit Committee and the Chairman of the Audit Committee shall be an independent director. The Audit Committee can transact any business only when at least two independent directors of the Committee are present.

Another requirement, though non-mandatory, of Clause 49 is the constitution of the Remuneration Committee. There shall be three non-executive directors in the Remuneration Committee and the Chairman of the Committee shall be an independent director.

Regarding ownership structure, the details of the promoters' shareholdings and the public shareholdings have to be periodically reported to the stock exchanges and the information is made available in the public domain for the benefit of the investors. When the promoters' acquisition of additional shares from the open market cross the specified threshold limits, it is obligatory for the companies to

report such acquisitions to the stock exchanges. Similar stipulations are also made whenever the directors and the promoters reduce their holdings. The recently introduced Companies Bill, 2012 has excluded the independent directors from retirement by rotation. Also, this Bill incorporates a separate Schedule IV stating the duties and responsibilities of the independent directors.

Obviously these requirements have been stipulated to make the Board function in an unbiased manner and to protect the interest of the public shareholders and other stakeholders. The number of the independent directors and the level of promoters' shareholdings are two very important requirements of the corporate governance framework in India.

METHODOLOGY

Bhagat & Black, 2000; De Nicolo *et al.*, 2006; Gompers *et al.*, 2003 and Kohli and Saha, 2008 used multiple regression model of quantitative design and examined the relationship between corporate governance and firm value. Demsetz and Villalonga (2001) also followed quantitative design of multiple regression models to examine the relationship between ownership structure variable and performance.

Studies in countries with developed stock markets (like the US and the UK) use Tobin's Q and PBV ratio as indicators of market measures of long term performance (Jayati Sarkar, 2010). Tobin's Q is widely used in literature as a market based measure to capture the value created by firms. However the definition of Tobin's Q has been modified and used, considering the difficulty faced in finding the market value of assets. The modified meaning of Tobin's Q followed is,

Tobin's Q = (Market Value of Equity +Book Value of Debt) / Book Value of Total Assets

The author, in this study, has used the following four models of multiple regression to ascertain the relationship between the firm value and corporate governance:

1. $MBV = \alpha0 + \beta1.ROCE + \beta2. CPM + \beta3.INDir + \beta4.PromShare + \varepsilon$
2. $MBV = \alpha0 + \beta1.ROCE + \beta2. CPM + \beta3.INDir + \beta4.PromShareCateg + \varepsilon$
3. $MCapSales = \alpha0 + \beta1.ROCE + \beta2. CPM + \beta3.INDir + \beta4.PromShare + \varepsilon$
4. $MCapSales = \alpha0 + \beta1.ROCE + \beta2. CPM + \beta3.INDir + \beta4.PromShareCateg + \varepsilon$

where, MBV = Market to Book Value

ROCE = Return on Capital Employed

CPM = Cash Profit Margin

INDir = number of independent directors

PromShare = per cent of the promoters' shareholding

PromShareCateg = 1 for firms having less than 51% of promoters shareholding

PromShareCateg = 2 for firms where promoters' shareholding is 51% and more

MBV is the same as PBV for all practical purposes. The usage of PBV has been supported in the literature as a measure of value creation (Bearer & Ryan, 1943; Fama & French, 1992, 1995).

DATA FOR ANALYSIS

Public sector and financial sector companies have been excluded from Nifty to make the sample a near homogeneous set of data for analysis. Corporate governance data, namely the number of independent directors and the percentage of promoters' shareholding of thirty one companies belonging to Nifty of the National Stock Exchange have been considered. One company was excluded from this list of 31 listed companies as the data contained extreme values. Thus the companies considered for analysis consist of thirty companies listed in the National Stock Exchange, all belonging to the private sector non-financial companies. The ratios used in the study were taken from the websites, *capitaline.com* and *moneycontrol.com.* The data relating to the number of directors and the promoters' shareholding were adopted from the annual reports of the individual companies. Each of the four models above cited have been tested for the published information for three years namely, 2012, 2011 and 2010.

FINDINGS

Multivariate analysis was conducted for the data collected for the thirty companies included in Nifty for the years 2012, 2011 and 2010 for the four models cited in the Methodology.

Model 1: MBV = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShare + ε
Coefficients

Year 2012			*Year 2011*			*Year 2010*		
	β	*Sig.*		*β*	*Sig.*		*β*	*Sig.*
Constant	6.624	0.024	Constant	1.888	0.492	Constant	-1.206	0.621
Independent Directors	-0.781	0.009	Independent Directors	-0.219	0.388	Independent Directors	0.140	0.541
Promoter Share	0.423	0.869	Promoter Share	1.432	0.542	Promoter Share	2.666	0.241
ROCE	19.460	0.000	ROCE	18.423	0.000	ROCE	14.534	0.000
Cash Profit Margin	-4.700	0.138	Cash Profit Margin	-3.548	0.482	Cash Profit Margin	0.705	0.885
R^2	0.756			0.764			0.771	

The overall model for the three years have high R^2 values of 0.756, 0.764 and 0.771, showing a strong relationship among the variables. Number of independent directors showed negative relationship with Market to Book Value for the years, 2012 and 2011 but positive relationship for the year 2010. However, excepting for

the year 2012, the coefficients were not significant either at 5% significance level or at 10% significance level. Regarding the promoters' shareholding, though this showed positive relationship with Market to Book Values, none of the coefficients were significant.

Model 2: MBV = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShareCateg+ε
Coefficients

	Year 2012			*Year 2011*			*Year 2010*	
	β	*Sig.*		*β*	*Sig.*		*β*	*Sig.*
Constant	6.159	0.049	Constant	1.908	0.493	Constant	-2.179	0.369
Independent Directors	-0.755	0.140	Independent Directors	-0.214	0.403	Independent Directors	0.168	0.444
Promoter Share Category	0.402	0.716	Promoter Share Category	0.560	0.575	Promoter Share Category	1.626	0.670
ROCE	19.128	0.000	ROCE	17.917	0.000	ROCE	13.362	0.000
Cash Profit Margin	-4.782	0.132	Cash Profit Margin	-3.834	0.453	Cash Profit Margin	0.380	0.435
R^2	0.757			0.763			0.789	

The overall model for the three years have high R^2 values of 0.757, 0.763 and 0.789, showing a strong relationship among the variables. Independent directors have negative relationship for the years 2012 and 2011 and positive relationship for the year 2010, but none of these values are significant at either 5% significance level or at 10% significance level. The results also show that the companies with the promoters' shareholding of 51% or more have positive Market to Book Value than those companies having less than 51% promoters' shareholding. However, these relationships have not been significant at both 5% and 10% significance levels.

Model 3: MCapSales = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShare+ε
Coefficients

	Year 2012			*Year 2011*			*Year 2010*	
	β	*Sig.*		*β*	*Sig.*		*β*	*Sig.*
Constant	0.521	0.736	Constant	-0.932	0.683	Constant	0.451	0.853
Independent Directors	-0.210	0.163	Independent Directors	0.013	0.950	Independent Directors	-0.161	0.483
Promoter Share	0.211	0.882	Promoter Share	0.365	0.852	Promoter Share	0.391	0.861
ROCE	2.235	0.098	ROCE	0.812	0.649	ROCE	0.336	0.842
Cash Profit Margin	12.933	0.000	Cash Profit Margin	21.315	0.000	Cash Profit Margin	22.309	0.000
R^2	0.735			0.550			0.531	

The overall model for the three years have R^2 values of 0.735, 0.550 and 0.531, showing a moderate relationship among the variables for the two years 2011 and 2010 and a strong relationship for the year 2012. Independent directors have negative relationship for the years 2012 and 2010 and positive relationship for the year 2011, but not showing statistically significant relationship at 5% or at 10% significance levels. Promoters' shareholding have all shown positive but not significant relationship for all the three years.

Model 4: MCapSales = α0 + α1.ROCE+ ß2. CPM + ß3.INDir + ß4. PromShareCateg+ε
Coefficients

Year 2012			Year 2011			Year 2010		
	β	*Sig.*		*β*	*Sig.*		*β*	*Sig.*
Constant	0.974	0.560	Constant	-1.045		Constant	-0.857	0.724
Independent Directors	-0.234	0.150	Independent Directors	0.018	0.931	Independent Directors	-0.105	0.635
Promoter Share Category	-0.171	0.780	Promoter Share Category	0.233	0.788	Promoter Share Category	1.064	0.226
ROCE	2.408	0.099	ROCE	0.589	0.766	ROCE	-1.281	0.479
Cash Profit Margin	12.987	0.000	Cash Profit Margin	21.160	0.000	Cash Profit Margin	21.371	0.000
R^2	0.736			0.551			0.557	

The overall model for the three years have R^2 values of 0.736, 0.551and 0.557, showing a moderate relationship among the variables for the two years 2011 and 2010 and a strong relationship for the year 2012. Independent directors have negative coefficients for the years 2012 and 2010 and positive coefficient for the year 2011. None of these coefficients for the independent directors have shown significant relationship for these years. Regarding the promoters' shareholding, the coefficients of companies having more than 51% promoters' shareholding have positive relationship with the MCapSales for the years 2011 and 2010 than those companies having promoters' shareholding of less than 51%. However, these coefficients have not been significant statistically at 5% or at 10% significance levels.

CONCLUSION

The evidence from the Indian stock market for the relationships found in the four models, namely,

1. MBV = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShare+ε
2. MBV = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShareCateg+ε
3. MCapSales = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShare+ε
4. MCapSales = α0 + β1.ROCE+ ß2. CPM + ß3.INDir + ß4.PromShareCateg+ε

has been mixed. The model having the market measure, Market to Book Value better reflects the relationship than the other market measure, Market Capitalization Sales ratio. Having accepted that Market to Book Value is a better market measure, Return on Capital Employed (ROCE) has proved to be an important control variable as its coefficient has shown statistically significant relationship with MBV at both the significance levels of 5% and 10%. The other control variable, Cash Profit Margin has significant relationship with the market measure MCapSales in all the years but not with the market measure, Market to Book Value ratio.

By and large, independent directors have shown negative relationship, though statistically not significant, with both the market measures of MBV and MCapSales ratios. Promoters shareholding have shown, on an overall basis, positive relationship with both the market measures, namely, MBV and MCapSales, though not significant. Also, the results have shown that the companies having 51% or more by way of promoters' shareholdings have better market values, measured by both the market measures, MBV and MCapSales, though these coefficients were not significant enough.

The results are consistent with the other studies relating to Asia and India as found by Chow and Kim (2007), Ghosh (2006) and Kota and Tomar (2010) which have not found any significant association with the presence of outside directors on the board. Khanna and Palepu (1999) and Singh and Gaur (2009) found in the Indian context that there was positive relationship between promoters ownership and firm value in the models investigated by them. Naveen Kumar (2012) found significant negative relationship between outside directors and firm value in their study relating to the Indian firms.

The findings of the study prove that the management and market dynamics of the Indian firms are different from those of the West. More number of independent directors and diffused ownership seem to be doing no good for the market values of the Indian companies. It is pertinent to recall Jamie Allen (2010) on what he said, "Yet after a decade of board reform, the broad perception is that independent directors and board committees have had only a superficial impact (if at all) on most listed companies. The major faux pas at India's Satyam Computers in 2008–2009 only served to further strengthen this view." Again Susela Devi (2004) stated that the effectiveness of majority independent directors is doubtful and whether it would be correct to stipulate the requirement when the availability of qualified independent directors is difficult to find and where the family owned firms are dominant. According to Haldea (2010), the current form of the institution of independent directors has not delivered the due benefits and it is worth considering other mechanisms to improve corporate governance.

It is suggested that the institutions upholding corporate governance and investor protection shall look at alternative mechanisms of improving the market valuations of the firms.

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