Governance and the Firm Performance: Empirical Evidences from the Indian Corporate Sector

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Abstract

Corporate Governance is putting in place the structure, processes and mechanisms by which business and affairs of the firm are managed to enhance long term shareholder value. In recent times, corporate scandals involving high incidence of improper activities have prompted the intense re-examination and scrutiny of the existing corporate governance practices and the firm performance across the globe. Present study developed a corporate governance score for a sample comprising 200 Indian companies. It studied the relationship between corporate governance and parameters of firm performance based on balance sheet data viz., net profit margin, earning per share and return of capital employed as well as market data in terms of dividend yield, risk adjusted excess return and the Tobin's q- measure.The study documented a strong relationship between the return on capital employed and the governance while the same was conspicuously absent for net profit margin and earning per share for balance sheet data. Similarly, it deciphered significant relationship between the dividend yield and Tobin's Q-measure for market data. It concludes that governance do not significantly influence the tangible firm performance. However, it cause management decisions for earnings payout to build 'positive self image' in the minds of investing community that influence firm capitalization at the market place.

1.0 Introduction

Corporate Governance is putting in place the structure, processes and mechanisms by which business and affairs of the firm are managed to enhance long term shareholder value. In recent times, corporate scandals involving high incidence of improper activities have prompted the intense re-examination and scrutiny of the existing corporate governance practices and the firm performance across the globe. Researchers have taken different variables as proxies for good governance and have divergent views on the emanating financial performance. Varied measures such as the Tobin's q-statistics, return on assets, sales margin, dividend yield, and price/earning ratio and asset turnover have been evolved and used to study the impact of governance on the firm performance. The present study intends to examine the impact of corporate governance practices on the firm performance for empiricism in the Indian corporate sector. More precisely, it is focused on the following objectives:

i) To study relationship between the corporate governance and the firm performance in terms of balance sheet data; and

ii) To study relationship between the corporate governance and the firm performance in terms of the market risk premium measures as Risk Adjusted Excess Return and Earning per Share.

2.0 Literature Review

Corporate Governance paradigm is based on the logic that separation of ownership and control leads to the problems associated with agency theory so that the managers (the agents) of a company may not act in the best interest of owners (the principals). Studies have also been carried to determine a link between varied aspects of corporate governance and firm performance and to see the impact of on Corporate Governance and the firm performance. There has been extensive literature to document a positive relationship between the two, based on identified individual aspects of corporate governance and firm performance whereas others do not find any conclusive evidence in this regard. Various arguments have been put forward both in support and against the notion of the effects of ownership structure on the firm performance. While some researchers denied the direct correlation between ownership structure and firms' economic performance while the others argued that there exists such a relationship for certain.

Mitton (2002) provides firm-level evidence that corporate governance helps explain firm performance. Brown, Robinson and Caylor (2004) constructed a composite measure of corporate governance, Gov-Score, comprising of 51 governance measures and the results stated that good governed firms were more profitable, carry more value, and distribute more cash to their shareholders as compared to poor governed firms. Bhagat and Bolton (2007) established the inter-relationships among Corporate Governance, corporate financial performance, capital structure and ownership structure. The study found that better governance, stock holdings of board members, and separation of CEO-Chairman positions is significantly positively correlated with better contemporary and consequent operating performance. While negative correlation exists between board independence and consequent operating performance.

Dharmapala and Khanna (2008) examined the effects of Corporate Governance reforms on firm value, using a series of Corporate Governance reforms in India presented a strong case for a causal effect of reforms on firm value. Balasubramanian (2008) et al. tested for the existence of cross-sectional relationship between various measures of corporate governance and firm's financial performance measures and found the positive correlation between composite governance index and an index dealing with shareholder rights. The overall association between the two variables was witnessed relatively strong for the profitable firms and firms with larger growth avenues.

McCahery, Sautner and Starks (2009) noticed majority of institutions take into account firm governance in portfolio weighting decisions and were willing to engage in activities that can improve the governance. Cremers and Nair (2005) stated that the interaction between shareholder activism and the market for corporate control is important in explaining abnormal equity returns and accounting measures of profitability. Aggarwal, Klapper and Wysocki (2005) have found that mutual funds also discriminate on the basis of governance to allocate more to the firms with better corporate governance structures.

Kaur and Gill (2007) established significant positive effect of institutional ownership on company profitability. It generated evidence for the fact that higher promoters' ownership (both in Indian and foreign companies) leads to higher corporate performance. Chhibber and Majumdar (1999) examined this further and found that only when foreign owners' control exceeds 51 percent, do firms display superior accounting performance. Abdul Wahab et al. (2007) found that institutional investors have a positive impact on firm's governance practices but not on the firm performance. Prasanna (2008) too observed that foreign investors invested more in companies with a higher volume of shares owned by general public. Foreign investors choose the companies where family shareholdings of promoters were not substantial and their investment decision is influenced by two performance variables i.e. stock returns and earning per share.

Douma, Rejie and Kabir (2006) further studied the impact of foreign institutional investment on the performance of emerging market firms and noticed a positive effect of foreign ownership on firm performance. Graham (2007) investigated the relationship between different classes of institutional investors (pressure-sensitive and pressure-resistant) and firm performance. It documented evidence leading to a possible two-way causality or endogenous problem between firm performance and ownership structure. Mohanty (2002) even noticed the development financial institutions have lent money to companies with better Corporate Governance measures. This positive association was because the mutual funds and development financial institutions have caused the financial performance of the companies to improve. On the other hand, Eisenberg et al. (1998) found negative correlation between board size and profitability using sample of small and midsize firms, and suggested that board-size effect existed even when there were less separation of ownership and control. Similarly, Kumar (2004)75 provided evidence that equity shareholdings by institutional investors and managers do not affect firm performance linearly even after controlling for observed firm characteristics and unobserved firm heterogeneity. The study also found that equity shareholdings by foreign investors and corporate shareholders do not influence firm performance. There was not found any evidence in favor of endogeneity of ownership structure.

Fich and Shivdasani (2004) asserted that firms with director stock option plans have higher market to book ratios, higher profitability (as proxied by operating return on assets, return on sales and asset turnover), and documented a positive stock market reaction when firms announce stock option plans for their directors. Klein (1998) studied whether the existence and staffing of board committees affects the Firm Performance and found little evidence that monitoring committees-audit, compensation, and nominating committees, usually dominated by independent directors-affect performance, regardless of how they are staffed. Bhagat and Black (1997) undertook the first large sample study (957 large public US corporations), with long time-horizon (1983-95), of whether the proportion of independent or inside directors affect firm performance and found no consistent evidence that the proportion of independent directors affects future firm performance, across a wide variety of stock price and accounting measures of performance.

Dalton et al. (1998), on the other hand, documented evidence that board composition had virtually no effect on firm performance, and that there was no relationship between leadership structure (CEO/Chairman) and Firm Performance. Bhagat and Black (2002) also found no linkage between the proportion of outsider directors and Tobin's Q, return on assets, asset turnover and stock returns. Sarkar and Sarkar (1999) even did not find any evidence of active involvement of institutional investors in governance practices of companies. Douma, George, and Kabir (2002) examined how ownership structure, namely the differential role played by foreign individual investors and foreign corporate shareholders affect the firm performance, using firm level data from India. The study noticed positive effect of foreign ownership on firm performance attributable to foreign corporations than to foreign institutional investors. Moreover, they did not find Indian financial institutions to be performing the monitoring task well.

3.0 Research Methodology

3.1 Hypotheses :

In order to achieve the objectives stated earlier, the present study conceptualized the following null hypotheses for validation the relationship between the corporate governance and firm performance:

H_{01}: That the Corporate Governance and firm performance for balance sheet data are closely related to depict a positive relationship between the two.

H_{02}: That the Corporate Governance and firm performance for market data are very closely related to depict a positive relationship for market data

3.2 Sample Design and Data :

The present study follows a descriptive research design given the objective and the standardized nature of the survey instrument as the findings describe the status of relationship between the governance score and identified parameters of firm performance. Initially, the survey was intended to research out to all (group A) listed firms on the NSE. In the process, a few of them were left out for non availability of data consistently throughout the study period, financial year 2003-04 to financial year 2007-08 and thus the sample comprised 200 companies. The data needed for construction of Corporate Governance Score(Index) is obtained from the Prowess database compiled and maintained by the Center for Monitoring Indian economy (CIME), Bombay under a licensing arrangement and from the official website of the Securities and Exchange Board of India (SEBI). While the same pertaining to the identified parameters of firm performance was compiled from the official web-site of the National Stock Exchange (market data) and from the annual reports of the sample companies (Balance Sheet data). This data set was compiled on the average annual periodicity.

3.3 Corporate Governance (Score) Index :

In order to test the null hypotheses stated above, corporate governance index is constructed for all 200 sample companies. The score on this index is the indicative of the status of governance of the corporate. It is constructed on the basis of dichotomous outcomes (yes/no) for disclosure of requisite information by sample corporate on the Standard & Poors' transparency and disclosure benchmark. Thus, the survey instrument comprised 98 questions in three categories and 12 sub-categories to balance the conflicting requirements of the range of issues analyzed and the tractability of the analysis. Transparency and Disclosure is evaluated by searching company annual reports for the 98 possible attributes broadly divided into the following three broad categories:

i) Ownership structure and investor rights (28 attributes)

ii) Financial transparency and information disclosure (35 attributes)

iii) Board and management structure and process (35 attributes)

Each question has been evaluated on a binary (dichotomous) basis to ensure objectivity, and rankings for the three broad categories and an overall ranking is developed from the answers to individual questions. Thus, the score of a particular corporate on the index is the number of positive responses deciphered on the 98 possible attribute scale outlined above (for details, see annexure-I)

3.4 Firm Performance Parameters :

In order to study the relationship between the Corporate Governance and firm performance different researchers have used different financial measures. Hermalin and Weisbach (1991) have taken Tobin's Q as the single measure of financial performance. Bhagat and Black (2002) took return on assets, asset turnover and stock returns. Bhagat and Bolton (2007) considered annual return, annual return on assets and annual Tobin's Q-statistics as performance variables. Brown and Caylor (2004) have used six industry-adjusted performance measures as return on equity, net profit margin, sales growth, Tobin's Q, dividend yield, stock repurchases. Mohanty (2002) has used Tobin's Q and stock returns as the measures of financial performance. In view of this, the present study identified six parameters of firm performance such as return on capital employed, net profit margin, earning per share, Tobin Q-statistics, risk adjusted excess return and the dividend yield. The former three were essentially based on the balance sheet data while the latter three on the market data set. These were obtained as:

i) Return on Capital employed :

= (Profit after tax/average capital employed) ×100

Capital employed represents share capital plus reserves and long- term debt of a company. It is arrived as Equity Capital + Preference Capital + Reserves and Surplus - Revaluation Reserve -Miscellaneous Expenses not written off + Total borrowing - (Bank Borrowing + Short- term commercial paper).

ii) Net Profit Margin :

= (Profit after tax/Sales) ×100

iii) Earning Per Share :

= (Net profit after tax/number of outstanding shares as on date)

iv) Risk- Adjusted Excess Return:

= $\{(R_i - R_m)/ß_i\} \times 100$, is a market return based measure of firm.

Wherein,

R_i is the average annual return on the ith stock R_m is that on the market, NSE (Nifty 50),

$ß_i$ is the measure of systematic risk of the ith stock.

v) Tobin's Q-statistics:

= {(Market capitalization + Book value of debt)/Book value of assets} ×100

Market Capitalization is obtained multiplying closing stock price and the number of outstanding shares as on date.

vi) Dividend Yield:

= (Face value of equity shares/closing stock price) × dividend rate

3.5 Statistical Tools :

Firm performance parameters and the governance score obtaining above were regressed in the Software Package for Social Sciences (SPSS) for analytical parameters in terms of constant (α), ß (regression co-efficient), standard error (SE), R^2 and t-values. In an offshoot to these analytical parameters Durbin-Watson, d-statistics is obtained as:

$$d = \frac{\sum_{t=2}^{n}(e_t - e_{t-1})^2}{\sum_{t=1}^{n} e_t^2}$$

wherein, e_t = difference between the actual value and the fitted values.

The results obtained in the stated framework are presented and analyzed in results and discussion section.

4.0 Results and Discussion :

As hypothesized (H01), good governance is expected to improve firm performance measured by net profit margin, earning per share and return on the capital employed as it involves changes in the firm structures, processes and mechanisms for conduct of the business. It is expected to reflect in accounting numbers reported in the balance sheet. On the basis of visible impact of governance interventions, regression results obtained for the study period encompassing from the financial year 2004 to 2008 are reported in table 1.

Table 1. Governance and Firm Performance, 2004-08 (Balance Sheet Data)

A) Net Profit Margin

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	-11.91	-0.45	5.18	-2.84	-2.99
Coefficient, β	0.13	0.11	0.05	0.16	0.18
R^2	0.02	0.01	0.00	0.03	0.03
S. E.	11.57	5.25	6.87	5.80	5.06
t-value (s)	1.87	1.60	0.73	2.28*	2.57*
d-statistics	1.93	1.96	2.00	2.12	1.99

B) Earning Per Share

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	-0.81	17.43	65.35	10.39	15.55
Coefficient, β	0.08	0.02	0.08	0.04	0.02
R^2	0.01	0.00	0.01	0.00	0.00
S. E.	16.83	19.67	36.04	14.02	20.74
t-value (s)	1.17	0.23	1.17	0.61	0.32
d-statistics	2.03	2.09	2.08	2.10	2.05

C) Return on Capital Employed

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	-12.99	-8.99	-3.73	-10.0	-8.20
Coefficient, β	0.26	0.25	0.18	0.31	0.25

R^2	0.07	0.06	0.03	0.09	0.06
S. E.	6.18	5.91	6.12	5.19	5.94
t-value (s)	3.74*	3.63*	2.60*	4.55*	3.59*
d-statistics	1.85	1.94	1.93	2.01	1.98

Note: i) Predictor: Governance Score for net profit margin, earning per share, capital employed, respectively.

ii) *significant t0.05 values at requisite degrees of freedom.

The study noticed a weak relationship between the parameters of firm performance based on balance sheet data and the governance score for net profit margin and earnings per share during the study period, 2004-08. However, a significant relationship is deciphered between the governance and the return on capital employed in the corresponding study period for sample corporates. Governance of sample companies could not significantly improve the net profit margin (as percentage of sales); however, the return on capital employed appeared having improved because of the valuation of productive assets on historical costs. It had also not significantly impacted the EPS either for higher financing costs commensurate with the return on the assets or for lower net profit margins. Therefore, based on the results reported in table 1 it appears very logical to observe that governance, pitched for higher transparency and disclosure, may not lead to improvements in tangible corporate performance in terms of balance sheet data. It may lead to 'positive self image' to cause higher premia in investors' decisions concerning investment in the stocks of that concern. The results obtaining in this regard are presented in table 2:

Table 2. Governance and Firm Performance, 2004-08 (Market Data)

A) Dividend Yield

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	-11.08	6.42	-13.7	-2.84	-2.99
Coefficient, β	0.28	0.11	0.16	0.27	0.18
R^2	0.08	0.01	0.16	0.27	0.18
S. E.	0.18	15.43	11.03	5.80	5.06
t-value (s)	4.11*	1.59	3.90*	2.27*	2.57*
d-statistics	1.86	2.06	2.06	2.12	1.99

B) Risk Adjusted Excess Return

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	339.43	176.58	8.17	-60.62	-8.32
Coefficient, β	-0.14	-0.14	0.01	0.09	0.00
R^2	0.02	0.02	0.00	0.01	0.00
S. E.	123.28	48.33	37.22	43.27	24.02
t-value (s)	1.93	2.06	0.20	1.33	0.07
d-statistics	2.10	1.91	2.12	1.88	1.87

C) Tobin's Q-measure

Regression Parameters	2004	2005	2006	2007	2008
Constant, α	-2.15	-1.03	-0.99	-1.98	-1.76
Coefficient, β	0.13	0.11	0.34	0.35	0.35
R^2	0.08	0.09	0.11	0.12	0.12
S. E.	0.13	0.68	0.67	0.85	0.83
t-value (s)	1.20	4.33*	0.73*	5.27*	5.23*
d-statistics	2.04	2.12	2.22	1.96	1.79

Note: i) Predictor: Governance Score for Dividend Yield, Risk Adjusted Excess Return and Tobin's Q-statistics, respectively.

iii) *significant t0.05 values at requisite degrees of freedom.

The results reported in table 2 reveals that governance has significantly influenced the dividend yield during the study period but the same has failed to yield significant influence on the risk adjusted excess return during the study period. In the absence of significant influence on the earnings, good governance might have been facilitated the higher earnings payout to improve the dividend yield. This further endorses earlier observation that corporate governance is not the good predictor for tangible corporate performance reported in terms of balance sheet data. On the other hand, corporate governance noticed as the strong predictor of firm performance obtaining in terms of Tobin's Q- measure. Market capitalization, book value of debt and total assets are three constituents of Tobin Q-measure, of these, book value of debt and total assets are key constituents which are also reported as balance sheet data. Further, as outlined earlier, governance is not a successful predictor for tangible corporate performance reported as balance sheet data. Therefore, governance is a successful predictor of firm performance in terms of market capitalization for market data.

Therefore, it is concluded that corporate governance focused to promote transparency and disclosure in the governance of corporate affairs in India do not significantly influence the firm performance reported in the balance sheet. However, it cause to influence management decisions for earnings payout thus to build 'positive self image' in the minds of investing community which significantly influence the market capitalization of firm performance in terms of market data.

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Annexure – I

Description of 98 Individual Transparencies and Disclosure Attributes

(1) Ownership Structure and Investor Rights (1-28)

a) Transparency of Ownership (1-11)

-Description of share classes (1)
-Review of shareholders by type (2)
-Provide the number of issued and authorized but non-issued ordinary shares (3)
-Provide the par value of issued and authorized but non-issued ordinary shares (4)
-Provide the number of issued and authorized but non-issued shares of preferred, non-voting, and other classes (5,6,7)
-Provide the par value of issued and authorized but non-issued shares of preferred, non-voting and other classes (8,9,10)
-Disclosure of voting rights for each class of shares (11)

b) Concentration of Ownership (12-20)

-Top 1,3,5, or 10 shareholders disclosed (12,13,14,15)
-Shareholders owning more than 10, 5, or 3 percent disclosed (16,17,18)
-Disclosure of percentage of cross-ownership of the company (19,20)

c) Voting and Shareholder meeting Procedures (21-28)

-Furnishing the calendar of important shareholder dates (21)
-Review of shareholder meetings (could be minutes) (22)
-Describe procedure for proposals at shareholder meetings (23)
-Procedure of convening an extraordinary general meeting of shareholders (24)
-Process of shareholders nominating directors to board (25)
-Describe the process of putting inquiry to board (26)
-Referring to or publishing of Charter or Code of best Corporate Governance practices in the company's annual report (27)
-Publication of the AoA or Charter Articles of Incorporation (28)

(2) Financial Transparency and Information Disclosure (29-63)

a) Business Focus (29-43)

-Discussion of corporate strategy (29)
-Report of the kind of business it is pursuing in detail (30)
-Giving an overview of trends in its industry by the company (31)
-Report of the products or services manufactured/provided (32)
-Provide the analysis of various segments broken down by business line (33)
-Disclosure of the market share of any or all of businesses of company (34)
-Details of basic earnings forecast of any kind by the company (35,36)
-Disclosure of output in physical terms (37)
-Giving an output forecast of any kind by the company (38)
-Disclosure of characteristics of assets employed in the company (39)
-Disclosure of efficiency indicators by the company (40)
-Providing any industry-specific ratios (41)
-Disclosing its plans for investment in the coming years (42)
-Disclosing details of its investment plans in the coming years (43)

b) Accounting Policy Review (44-52)

-Providing financial information on a quarterly basis (44)
-Discussion of company's accounting policy (45)
-Disclosure of accounting standards it uses for its accounts (46)
-Providing accounts according to the local accounting standards (47)
-Providing accounts by the company in alternate internationally recognized accounting method. Providing each of the balance sheet, income statement, and cash-flow statement by internationally recognized methods (48,49,50,51)
-Furnishing a reconciliation of its domestic accounts to internationally recognized methods (52)

c) Accounting Policy Details (53-55)

-Disclosure of company's methods of asset valuation (53)
-Disclosure of information on method of fixed assets depreciation (54)
-Furnishing consolidated financial statements of the company (55)

d) Related Party Structure and Transactions (56-59)

-Provide a list of associate companies in which it carries a minority stake (56)
-Disclosure of ownership structure of company's affiliates (57)

-Providing a list/register of related party transactions (58)
-Providing a list/register of group transactions (59)

e) Information on Auditors (60-63)

-Disclosure of the name of the company's auditing firm (60)
-Reproduction of firm's the auditor's report (61)
-Disclosure of amount of audit fees paid to the auditor (62)
-Disclosure of any non-audit fees paid to auditors (63)

(3) Structure of Board and Management and its Process 64-98)

a) Board Structure and Composition (64-71)

-Disclosure of the name of the chairman (64)
-Description of the details, vital information, about the chairman (65)
-Disclosure of a list of board members (names) (66)
-Details about directors (other than name/title) (67)
-Details about current employment/position of directors (68)
-Furnishing of details about previous employment/positions (69)
-Mentioning of the dates of joining of directors on the board (70)
-Classification of directors as executive or outside directors (71)

b) Role of Board (72-83)

-The role of Board at the company disclosed in detail (72)
-Disclosure of list of matters reserved for the board (73)
-Furnishing of list of board committees (74)
-Review of last board meeting (could be minutes) (75)
-Mentioning the existence of an audit committee (76)
-Disclosure of names on audit committee (77)
-Mentioning of remuneration/compensation committee (78)
-Names on remuneration/compensation committee (79)
-Disclosure of nomination committee (80)
-Names on nomination committee (81)
-Other internal audit function besides audit committee (82)
-Existence of any strategy/investment/finance committee (83)

c) Director Training and Compensation (84-89)

-Disclose whether they provide director training (84)
-Disclose the number of shares in the company held by directors (85)
-Discuss decision-making process of directors' pay (86)
-Specifics of directors' salaries disclosed (numbers) (87)
-Form of directors' salaries disclosed (cash, shares, etc.) (88)
-Specifics disclosed on performance-related pay for directors (89)

d) Executive Compensation and Evaluation (90-98)

-Names of senior managers who are not on the board (90)
-Details (background information) of senior managers disclosed (91)
-Disclose the numbers of shares held by the senior managers (92)
-Disclose the number of shares held by managers in associated companies (93)
-Disclose the process of decision-making of manager's pay not on the board (94)
-Numbers of managers' (not on board) salaries disclosed (95)
-Form of managers' (not on board) salaries disclosed (96)
-Specifics disclosed on performance-related pay for managers (97)
-Details of the CEO's contract disclosed (98)