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Corporate Governance and Firm Performance: Empirical Evidence from India

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Abstract— **Trends, dimensions and issues relating to corporate governance are attracting the attention of academicians, industry experts, policy makers, researchers and others. As interest into the nitty-gritty of corporate governance gets intensified, the focus shifts to the emerging areas of corporate governance. Among the emerging areas of interest, the linkage between corporate governance and firm performance is fast assuming a significant place among researchers. Research on the linkage between corporate governance and firm performance has provided mixed and contradictory results and there is need to examine this linkage in the light of the Indian perspective. In this backdrop, the present paper tries to examine the linkage between corporate governance and firm performance of 30 companies of BSE Sensex by using latest available data. The paper starts with a discourse on corporate governance and a brief survey of existing literature on the issue has been carried out. Based on the guidelines available in existing literature, certain objective measures of corporate governance like proportion of independent directors, segregation of power between Chairman and CEO, presence of owner- managers, number of board meetings, pattern of institutional share holding etc. and measures of firm performance like net profit margin, return on net worth etc. have been considered. Data corresponding to these measures have been collected from reliable data sources. Regression analysis has been carried out to examine the nature of linkage between corporate governance and firm performance. The results have been analyzed and inference has been drawn accordingly.**

I. CORPORATE GOVERNANCE: A SYNOPTIC VIEW

Trends, dimensions and issues relating to corporate governance are attracting the attention of academicians, industry experts, policy makers, researchers and others. As interest into the nitty-gritty of corporate governance gets intensified, the focus shifts to the emerging areas of corporate governance. The issue of corporate governance emanates from the separation of ownership from control in modern organizations (Berle and Means, 1932; Zahra and Pearce, 1989). It is generally observed that an 'agency problem' occurs when managers serve their own interest at the expense of the shareholders (Wiliamson, 1984; Fama and Jensen, 1983). In this circumstance, an important task pertains to formulation of an appropriate course of action to get rid of this problem and in this context that the role of corporate governance has been generally highlight. Although the issue of corporate governance has received a lot of attention, there is considerable difference in the conceptual definitions, which has resulted in variations in the usage of the term. The Report on the financial aspects on Corporate Governance defines it as 'The system by which companies are directed and controlled.'(Cadbury, 1992). In a broad sense, Corporate Governance deals with all the factors and forces, both internal and external to the organization, that work to harmonize the interests of managers and shareholders (Baysinger and Hoskissson, 1990). It has also been defined as "**…**the process whereby people in power direct, monitor and lead corporations, thereby create, modify or destroy the structures and systems under which they operate. Corporate governors are both potential agents for change and also guardians of existing ways of working "(McGregor, 2000). Governance is considered as a systematic process in which people who govern take decision that 'create, destroy or maintain social system, structure and process. So the process of Corporate Governance is formulated and implemented by the people involved in the process. But conventional discussions on Corporate Governance tend to de-emphasize this aspect, which is essential for any comprehensive discussion on the issue. Traditional discussions on Corporate Governance talk about an organization's primary goal of maximizing shareholder's wealth in a legal and ethical manner that involves three main players namely the shareholders, the management and the directors. The shareholders have trusted the company and invested their capital, the management runs the company, which is accountable to the directors, and the directors in turn are answerable to the shareholders.

In the light of the ever-increasing importance of corporate governance, several Corporate Governance Codes and Principles have been formulated in different countries and in our country as well. In India, the Confederation of Indian Industry (CII) formulated Code on Corporate Governance which recommended about the composition of the board, appointment of non-executive directors, information to be placed before the board, disclosure etc. SEBI appointed the Birla Committee which recommended guidelines relating to the composition of the board, nominee directors, remuneration committee, audit committee, disclosure norms, declaration of financial performance etc. The Naresh Chandra committee Report suggested recommendations on various aspects such as role, remuneration and training of the independent directors, audit committees, the auditor and their relationship with the company. The Narayana Murthy committee focussed mainly on the role of the audit committee and the board composition, mainly the independent directors.

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II. CORPORATE GOVERNANCE AND REVIEW OF LITERATURE

Research on the linkage between corporate governance and organizational performance has provided mixed and contradictory results (Chatterjee and Harrison, 2001). Some researchers have established a positive relation between organizational performance and corporate governance (Cochran, Wood and Jones, 19985; Kasner, 1987). While others have established neutral relation between organizational performance and corporate governance (Daily and Johnson, 1997; Mallet and Fowler, 1992). A third category of researchers has found a positive relationship between proportion of outside directors and organizational performance (Hill and Snell, 1988, Pearce and Zahra, 1992). Moreover, one interesting research finding is that foreign investors contribute positively to corporate performance in terms of profitability while the government financial institutions contribute negatively. Many studies have been conducted to examine the board performance relationship. However, no consistent empirical evidence has yet been found (Hermalin and Weisbach, 2000). Certain aspects of different governance mechanisms such as the proportion of outsiders, inside ownership, ownership structure etc have been identified by some other studies (Bozec, 2005; Prevost et al., 2002; Rediker and Seth, 1995; Bhatala and Rao, 1995). Studies on development country perspective suggest that the proportion of shares held by institutional investors significantly influence firm performance (Leng 2004). Measuring firm performance using accounting ratios is also common in corporate governance literature (Demsetz and Lehn, 1985; Ang et al, 2000), in particular, net profit margin.

III. METHODOLOGY

A. Estimation procedures

Based on the guidelines available in existing literature, it has been assumed in this study that firm performance =f (corporate governance indicators and efficiency variables of firms). In this study firm performance is measured with the help of net profit margin, which is a common measure of firm performance. The variables that have been considered as corporate governance indicators are Proportion of Independent directors, separation of power between CEO and Chairman, presence of owner-managers in the board, number of boar meetings and percentage of institutional shareholding. The efficiency variable considered as net sales and market capitalization. In this backdrop, the following hypotheses have been drawn:

H1: Ceteris paribus, Proportion of Independent directors and net profit margin will be positively associated.
H2: Ceteris paribus, non-separation of power between CEO and Chairman and net profit margin will be negatively associated.
H3: Ceteris paribus, presence of owner-managers in the board and net profit margin will be negatively associated.
H4: Ceteris paribus, number of board meetings and net profit margin will be positively associated.
H5: Ceteris paribus, percentage of institutional shareholding and net profit margin will be positively associated.

With regard to the control variables, the hypotheses are as follows:

H6: Ceteris paribus, net sale and net profit margin will be positively associated.
H7: Ceteris paribus, market capitalization and net profit margin will be positively associated.

B. Variable definition and predicted effect on net profit margin

Variable	Notation	Definition	Predicted effect on net profit margin
Net Profit Margin (Dependent)	npm	Adjusted Profit after Tax/Net Sales	×
Independent directors (Independent)	ind_dire	Percentage of independent directors in the board	+
CEO-Chairman separation (Independent)	ceo_chmn	If CEO and Chairman are same then, 1 otherwise 0	–
Owner manager (Independent)	ceo_prom	If CEO is a promoter or owner, 1 otherwise 0	–
Board Meeting (Independent)	bd_meet	Total number of board meetings held during a financial year	+
Institutional Shareholding (Independent)	inst_sha	Percentage of institutional share holding	+
Net Sales (Control)	net_sale	Net sales	+
Market Capitalization (Control)	mkt_cap	Market Capitalization	+

C. Regression model

The basic regression model considered in this study can be stated as follows:

$$npm= a+b_1(ind\_dire)+b_2(ceo\_chmn)+b_3(ceo\_prom)+b_4(bd\_meet)+b_5(inst\_sha)+b_6(net\_sale)+ b_7(mkt\_cap)+e$$

(When net profit margin is a dependent variable)

D. Data

Data relating to the study has been collected from Capitaline Data base which is developed, maintained and marketed by Capital Market Publishers Pvt. Ltd.,Mumbai. The time span for the present study covers a single time period corresponding to the financial year 2012-13. Here the last complete financial year for sample companies have used since it is mainly a cross-sectional study. Data related to sample companies is valid as on the last date of each company's financial year (31st March, 2013 or 31st December 2012, as the case may be based on the financial year followed by different companies). The companies belonging to BSE Sensex have been considered in this study. The basic justification for considering the companies belonging to BSE

Sensex can be ascribed to the fact that BSE Sensex represents the most significant indicator in the secondary capital market. The data corresponding to the different companies under consideration is summarized in Table 1 in Appendix.

IV. RESULTS AND INTERPRETATIONS

The results of the above analysis provide important insight into the issues of corporate governance and corporate governance linkage. Descriptive statistics of the data set is shown in Table 2. Correlation coefficients among dependent and independent variables are shown in Table 3. In this paper, the researcher is restricting the discussion within the domain of regression analysis. From the model summary (Table 4), and ANOVA chart (Table 5), it can be inferred that the model is statistically significant at a confidence level of 97.8% which is reflected in its p-level of F value i.e. 0.022. A moderate value of R^2 indicates that 66% of variation of npm is being explained by all the independent variables. The regression coefficient chart (Table 6) shows some interesting results. It was hypothesized that the proportion of independent directors and npm would be positively associated (H1). The result shows that the proportion of independent directors has a moderate positive relationship with npm. It can be inferred that the strength of the independent directors on the board as reflected on firm performance is not as strong as commonly perceived. The dummy variables CEO_CHMN (i.e. both CEO and Chairman are the same person) shows high negative association with npm. The direction of relationship CEO_CHMN and npm are in the same line as was predicted. But that is not statistically significant. The results confirm that ceteris paribus, if CEO and Chairman are the same person then it decreases the firm performance (H2). It was also hypothesized that the owner-manager's (CEO_PROM) presence on the board reduces net profit margin (H3). But the results indicate an opposite direction of relationship, which is hard to explain. The regression coefficient of the variable BD_MEET (i.e. number of board meetings) also shows moderate positive relationship with npm though not in a statistically significant manner. The results confirm that number of board meetings have a positive impact on firm's financial performance (H4). The predicted relationship between INST_SHA (i.e. percentage of institutional shareholding) and npm was positive (H5). The results exhibit that INST_SHA has a moderate positive and statistically significant relationship with npm. It shows that the monitoring role of the large institutional investors has an important effect on firm performance. The last two predictor-variables have been used in the model to control the two dummy variables (i.e. CEO_CHMN and CEO_PROM) used in this model. In this case results have indicated a strong statistically significant relationship in the same line as was predicted (H6 and H7).

CONCLUSIONS

From the above analysis it is clear that certain aspects of corporate governance are related to firm performance. This paper highlights the important role of large financial institutions in the context of corporate governance. Moreover, "duality" in leadership structure (CEO-Chairman) and proportion of independent directors are significant issues in the area. The impact of total number of board meetings on corporate governance practices has not been validated in the study. Finally, contrary to the common belief, it is found that the presence of owner-managers has a positive impact on firm performance. These findings might not be generalized, since this study is based on data on a limited number of companies on a single period. More empirical research is necessary to highlight certain other issues.

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Appendix

Table 1

Co. Name	Prop. of Independent Directors	CEO-Chairman	CEO-promoter	No. of board-meetings	Institutional Share holdings	Net Sales	Market Capitalisation	NPM
B H E L	0.50	1	0	11	27.32	13442.57	54996.35	11.39
Bajaj Auto	0.53	1	1	6	30.29	7488.11	27792.63	12.85
Bharti Airtel	0.56	1	1	4	39.48			17.92
Cipla	0.67	0		6		2897.41	19848.57	20.12
Coal India	0.33	0	0	5	45.72	3160.18	9856.52	8.35
Dr Reddy's Labs.	0.67	1	1	6	17.42	2005.85	10893.7	8.83
GAIL	0.64	0	0	4	32.6	6640.71	18869.34	11.35
H D F C Bank	0.33	1	0	6	37.23	4475.34	24221.38	
H D F C	0.69	0	0	6	73.96	4208.37	33342.46	29.34
Hero Motocorp	0.50	1	1	6		8708.2	17739.35	9.63
Hindusthan Unilever	0.38	0	0	7	28.41	11080.31	43418.67	11.77
Hindalco Inds.	0.50	1	0	9	37.44	11122.1	21151.43	13.57
ICICI Bank	0.65	1	0	6	62.13	13784.5	52435.59	
Infosys Tech.	0.53	0	0	5	47.62	9028	81830.29	26.82
ITC	0.50	1	0	7	50.53	9786.34	73205.67	13.78
Jindal Steel & Power	0.33	0	0	10	47.73	2600.48	7976.21	15.46
Larsen & Toubro	0.50	1	0	11	61.48	14739.98	33423.92	5.76
Mahindra & Mahindra.	0.64	0	0	6	34.03	3575.44	13495.36	4.71
Maruti Suzuki	0.36	0	0	8	30.8	12015.9	25261.72	8.06
NTPC	0.11	1	0	16	6.83	26318.6	110489.16	22.11
O N G C	0.27	1	0	14	10.71	47970.6	186725.53	29.91
Reliance Inds.	0.58	1	1	11	28.85	80877.79	110958.23	10.18
Sesa Sterlite	0.50	1	1	8	39.77	3976.9	12989.74	16.35
Sun Pharmaceutical	0.33	0	0	10	47.73	2600.48	7976.21	15.46
S B I		1	0	47		35794.93	50948.47	
TCS	0.67	0	1	8	10.54	11236.01	93659.36	
Tata Motors	0.31	0	1	8	39.04	20271.51	35707.39	6.46
Tata Power								
Tata Steel	33.33	0	0	7	43.16	15139.39	29688.13	20.45
Wipro	0.83	1	1	11	6.23	10264.09	79649.23	19.68

Table 2:

		Std.	

Table 3:

Correlation								
(1-tailed)								

Table 4:

			Adjusted	Std. Error of the

Predictors: (Constant), NET_SALE, IND_DIRE,
CEO_PROM, INST_SHA, CEO_CHMN, BD_MEET,

Table 5:

	Sum of		Mean		

Predictors: (Constant), NET_SALE, IND_DIRE, CEO_PROM, INST_SHA,

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Table 6:

	Unstandardized		Standardized Coefficien		

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