Relationship between Corporate Governance Practices and Firms Performance of Indian Context

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Abstract - *The aim of the present study to identify the relationship between corporate governance disclosure practices and firms performance with respect to profitability. For the purpose of present research insights undertaken ten manufacturing forms which are listed in BSE stock exchange across different sectors. The source of data collected form CMIE and respective companies and framework of content analysis through disclosure of annual report and corporate governance reports. The statistical analyses were made to measure the relationship and its impact with the help of correlation and regression analysis. The study implied positive and significant impact with the corporate governance disclosure and firms performance of manufacturing firms in India.*

Key Words: Corporate Governance Disclosure, Firms Performance, Return on Assets, Profitability.

1.INTRODUCTION

India has a range of business forms, including public limited companies which are listed on stock exchange, domestic private companies and foreign companies. Foreign portfolio investment was permitted since 1992 and foreign institutional investors also began to play an important role in the institutionalisation of the market. The securities market was transformed as disclosure requirements were brought in to help protects shareholders interest. In recent scenario, corporate has been initiated by the protection of the shareholder interest for looking forward focusing of the corporate governance initiatives also very crucial. The SEBI report emphasise the importance of corporate governance to future growth of the capital market and the economy which is three key aspects underlying as accountability, transparency and equality of treatment for all stakeholders. Corporate governance can be viewed as a mechanism that ensures external investors receive proper returns on their investments. Effective corporate governance provides an assurance on the safety of the invested funds and the returns on investment (Shleifer and Vishny, 1997). The corporate governance framework should ensure that timely and accurate disclosure is made of all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company (OECD, 2004).

2. LITERATURE REVIEW

Generally research on corporate governance and performance is based on the principal-agent theory in which principal or owners and agents or managers have opposing preferences regarding disclosure. Therefore our study is also formulated on the grounds of the 'agency theory' of corporate governance, where the management or board acts as agent and owners, i.e., equity share holders, are principal. Some studies suggest a positive and significant relation between corporate governance and firm performance, whereas some researchers disagree on the point. There is no unanimous consent on the results of the studies (Patterson, 2000). Agency problems and information asymmetries between owners and managers can be overcome with the help of enhanced corporate transparency (Jensen and Meckling, 1976).

Ownership structure of the Indian firms is characterized with family ownership, block holdings and business groups. Poor law enforcement, corruption, weak legislative and regulatory framework and poor implementation of the property rights are the main causes for the concentrated ownership in India, which further results in agency problems. Weak legal protection of property rights in emerging markets discourages informed arbitragers to capitalize on firm-specific information (Morck et al., 2000).

Botosan (1997) states that "Although the annual report is only one means of corporate reporting, it should serve as a good proxy for the level of voluntary disclosure provided by a firm across all disclosure avenues. Despite considerable regulatory effort and theoretical and empirical research on fair disclosure, it is still a debatable question of: to disclose or not to disclose. For instance, the effect of disclosure on the cost of capital can be observed in two ways. Firstly, the greater the disclosure, the lower will be the cost of equity capital. Secondly, increased disclosure will enhance the share price volatility, which will further result in higher risk and cost of capital.

A study by Hassan et al. (2008) aims at investigating the relationship between corporate governance, transparency and firm performance. The study focuses on examining the effect of good corporate governance practices on the corporate transparency and performance of the 142 companies listed on the Malaysian Stock Exchange. For the empirical analysis, Tobin's Q represents the dependent variable, while seven corporate governance characteristics, viz., board independence, board leadership or role duality, quality of directors, insider ownership, foreign ownership, debt financing and audit quality, are the independent variables. The result of the study reveals that corporate governance components have strong predicting power on the company's performance. The relationship between audit quality and performance of the firm was found to be negative. The findings further suggest that firm performance is insignificant and not related to the components of transparency, viz., level of disclosure and timely reporting. It further propounds that disclosure and timely reporting are not significant contributing factors in the relationship between corporate governance and firm's market performance.

A study by Lee (2008) on Korean firms examines the relationship between co prorate governance and firm's financial performance. In this study, the effect on Korean firms is empirically tested. The study is based on the agency theory of corporate governance. Ownership concentration and ownership identity are taken as two components of corporate governance, and Net Income to Total Assets (NIA) ratio and Ordinary Income to Total Assets (OIA) ratio are taken as performance variables. The study with the multivariable regression analysis reveals the significant linear lump-shaped relationship between ownership concentration and firm performance and insignificant relationship between ownership identity and firm performance. In a nutshell, the study shows a positive and significant relationship between corporate governance and firm's financial performance.

In another study based on Chinese firms, Zhen et al. (2010) tried to find the relationship between corporate governance and corporate performance of 106 high-tech small and medium-size enterprises in China. The study, through empirical analysis, finds that the relationship between ownership concentration and corporate performance follows a positive correlation. It further states that the relationship between shareholding ratio of the 2nd to 10th shareholders, number of board and shareholders meetings and executive remuneration shows a positive and significant relationship with corporate performance.

A study reveal that the large cap and mid cap firms with their good corporate governance practices have shown better financial results, but the scenario in the case of small cap firms is different. In some of the cases, the firms with poor corporate governance practices are also performing well. The study results also suggest that the corporate governance policies and transparency and disclosure are positively correlated. It means, we can say that the firms with good corporate governance policies and practices have greater transparency and disclosure as compared to the firms with poor corporate governance practices. India is gradually moving towards a more structured corporate governance framework (Jyotsna and Pankaj, 2013).

The impact of corporate governance on both shareholders and stakeholders in mentioned as earlier literatures, although the corporate objective is seen as one of the maximizing shareholders value, and indeed the views the fundamental objective of corporate governance as 'enhancement of shareholders' value, keeping in view the interest of the other stakeholders'.

Research Questions

1. Do firms with greater transparency and higher level of disclosure have better corporate governance? And Do such firms perform well financially?
2. Do the firms with better corporate governance policies and practices have good financial performance in the Indian context?

3. OBJECTIVES OF THE STUDY

1. To study the overall corporate governance and disclosure practices in sample firms;
2. To measure the extent of relationship between corporate governance and disclosure practices of sample firms and firms performance.
3. To analyse the impact of the corporate governance disclosure of firms from different sectors and its financial performance in terms of profitability.

4. DATA AND METHODOLOGY

Primarily secondary data has been used in this descriptive research. To carry out the research study, analysis was limited to one-year period because disclosure policies usually tend to remain constant over time (Botosan, 1997). For the purpose of study, data of the sample firms was collected from their annual reports for the year 2013-14. The annual report of year 2014- was chosen because it is relatively more recent and easier to obtain. Annual reports are important documents for assessing and analyzing the company performance in regard to corporate governance standards and compliance. The annual reports of 13 firms for the period ending March 2014 (based on the firms' financial year) were download from the CMIE Prowess database as well as from the company websites. This study focuses on selected a manufacturing industry which is listed in BSE stock exchanges. We had to drop some firms for which we could not gather information on key independent variables. This resulted in a final sample size of 10 firms, across different background of manufacturing of the Indian context.

5. RESULTS AND DISCUSSION

The CGD score was calculated for all 10 firms in the sample and Table 1 shows the mean CGD scores across various sectors. Thus, the IT firms are found to have the highest corporate governance disclosure. This could be attributed to the fact that the firms in this sector have seen great expansion in the last few years. Out of 10 firms in manufacturing sector, Infosys listed abroad (US). As a consequence, the firms in these sectors have had to meet the disclosure requirements of two countries, i.e., the home country and the country of listing host country. Further, the CGD score for FMCG sector firms is found to be higher as compared to other sectors in the sample.

Table -1: Sample Firms with CGD Score

Sl.No	Name of the firm	Sector	CGD Scores
1	Infosys	IT	47
2	ITC	FMCG	44
3	Larsen and Turbo	Automobile	41
4	Sun Pharma	Health Care	38
5	Bombay Dyeing	Textile	37
6	Aditya Birla	Cement	36
7	Asian Paints	Paints and Chemicals	33
8	Jindal	Steel	32
9	Appolo Tyres	Tyres	30
10	DHL	Logistics	29
Source: Computed			

5.1 Variables Used

The study has undertaken by Return On Assets (ROA) as the dependent variables. ROA is one of the accounting based measures of performance, commonly used to measure firm's performance. The previous literatures also used Return on Equity (ROE) and Return On Sales (ROS) as alternate performance indicators but found the results to be qualitatively similar. We obtained the data on ROA from the CMIE database.

Explanatory Variables: Board Index (Board Size, Outside Directors, Independent Directors and Board meeting), Ownership concentration Index (Promoter as Ownership), Audit Committee Index, and Shareholding Pattern were the key explanatory variables. The ownership concentration variable was skewed, so we performed a logarithmic transformation on this variable. We measured board independence index by taking a natural logarithm of the number of independent directors in the board.

Control Variables: The previous studies were used for control variables such as firm age, firm size, level of diversification, board size, and country membership. While firm age and firm size are standard controls in any study investigating the performance differential between firms. Thus, Size included as a control to account for the performance.

This study has been performed a moderated regression analysis to investigate the performance consequences of within firm governance variables and those modeling procedure minimizes the problem of multi-collinearity arising due to correlations between the main effect variables used for the study.

5.2 Correlation Analysis

The table 2 shows that correlation matrix of dependent and independent variables used in the study. The relationship between overall CGD score and ROA has positive which is also significant (p value <0.01). The board index, ownership index and audit committee variables also positively correlated with the firm's performance which is significant ate 5 per cent level. The shareholding index has negative relationship has been found with firms performance which is also significant at 1 per cent level.

Table -2: Correlation between Corporate Governance Disclosure and Firms

		CGD	Board Index	Ownership Index	Audit Committee	Shareholding Index	Size	ROA
CGD	r	1	.756**	.492**	.041*	-.366**	.378**	.349**
	Sig.		.000	.000	.020	.012	.001	.001
	N	10	10	10	10	10	10	10
Board Index	r		1	.412**	.202	-.438**	.102	-.280*
	Sig.			.000	.072	.000	.370	.012
	N		10	10	10	10	10	10
Ownership Index	r			1	.215	-.187	.241*	.230*
	Sig.				.056	.097	.031	.040
	N			10	10	10	10	10
Audit Committee	r				1	-.177	-.306**	-.113
	Sig.					.116	.006	.319
	N				10	10	10	10
Shareholding Index	r					1	-.156	.485**
	Sig.						.166	.000
	N					10	10	10
Size	r						1	.590**
	Sig.							.000
	N						10	10
ROA	r							1
	Sig.							
	N							10

5.3 Regression Analysis

The multiple correlation coefficients between the dependent variable ROA and the independent variables taken together were 0.841. It is also evident that from the table of R square that 70.5 per cent variation in ROA was accounted by the joint variation of independent variables. The result of linear regression shows that significant at 1 per cent level (p value <0.01). Hence, the hypothesis states that "There is no significant influencing the variables between firms performance and the selected independent variables", does not holds well. Therefore, there was a significant impact on firm's performance and its selected independent corporate governance variables of manufacturing firms in India. The Durbin-Watson value of 1.069 shows that there is presence of positive serial correlation among the variables.

Table -3: Linear Regression Model Summary

Multiple R	R Square	Adjusted R Square	Std. Error of the Estimate	F	Sig.	Durbin-Watson
0.841	.705	.667	463.4814	18.584	.000	1.069

The strength of the relationship between the dependent variable (ROA) and all the independent variables taken together of selected automobile companies and the impact of these independent variables were given in Table 4. It could be observed that an increase in Board Index by one unit; the ROA increased by 38.923 units which is statistically significant at 0.01 level. Similarly, ownership index has increased by one unit; firms performance also increased by 43.655 units which found that significant at 0.05 level.

Table -4: Regression Co-efficient of Manufacturing Firms

Factors	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-1736.686	565.625		-3.070	.003
Board Index	38.923	7.530	.544	5.169	.000
Ownership Index	43.655	26.000	.233	1.679	.048
Audit Committee	1.134	.687	.132	1.649	.104
Shareholding Index	-14.966	61.947	.028	-.242	.810
Size	337.834	98.162	.351	3.442	.001

It was found that Audit Committee has a positive association with ROA. It could be observed that strengthen of the audit committee which is an effect of increase in ROA, such as increased by 1.134 units which is statistically insignificant. Therefore, the null hypothesis accepted and it implies that audit committee of a firms have a positive influence on its firms performance. It could be observed that an increase in Shareholding Index by one unit; the ROA decreased by 14.966 units which is statistically insignificant. Therefore, shareholding index has combined effect of insignificant, thus the null hypothesis accepted and it implies that "shareholding index of a firm has negative impact on its firm's performance. Finally, It was found that size have a positive association with ROA. It could be observed that an increase in size by one unit; the ROA increased by 337.834 units which is statistically significant at 0.01 level. Therefore, the null hypothesis rejected and it implies that size of the company have a significant and positive influence on its firms performance.

6. CONCLUSIONS

The corporate governance is the system by which companies are directed and controlled in efficient manner. It involves regulatory and market mechanisms, and the roles and relationship between a firm's management, its board, its shareholders and other stakeholders and goals for which the corporation is governed. The qualitative analysis indicates that the IT companies still have a long way to go in order to achieve excellence in their corporate governance practices. This study has been identified the positive relationship between the corporate governance disclosure and firms performance. Hence, it was found that a significant and positive influence of the corporate governance disclosure in terms of firms financial performance. The study results also suggest that the corporate governance policies and transparency and disclosure are positively correlated with the firm's performance. Hence, firm's performance with good corporate governance policies and practices has greater transparency and disclosure as compared to the firms with poor corporate governance practices.

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