

# DO CORPORATE GOVERNANCE PRACTICES DIFFER ACROSS DIFFERENT MARKET CAPITALIZATION OF THE FIRMS: SOME EMPIRICAL FINDINGS FROM INDIA?

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## Abstract

Worldwide considerable amount of research on corporate governance focuses on ownership structure and board characteristics of companies and linking these to their performance but fewer studies have been found on the linkage between market capitalization of the firms and the quality of corporate governance practices. This study is an attempt to showcase the linkage between market capitalization and quality of corporate governance practices of the firm. The purpose of this paper is to study the impact of firms with different market capitalization on the quality of corporate governance in Indian companies. As India is one of such countries where corporate governance systems are in the evolutionary stage, the findings could also be useful for other newly liberalized and globalizing economies.

**Keywords:** Corporate Governance, Quality, Large Cap Firms, Mid Cap Firms, Small Cap Firms

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## 1 Introduction

Corporate governance has become the buzz word for all the bad reasons and the scam unearthing all over the world. The beginning of the twenty first century was marked by the array of reforms in corporate governance practices in response to the collapse of several high profile corporations in America and other parts of the world. The business community was shaken beyond belief both with the scale and degree of illegal and unethical corporate governance practices. Corporate governance structures and systems vary greatly across countries and industry sectors. Maher and Andersson (1999) globally classify systems of corporate governance into two broad categories based on the degree of ownership and control and the identity of controlling shareholders. One the outsider systems (notably the US and the UK) characterized by widely dispersed ownership and the other insider systems (notably continental Europe and Japan) characterized by concentrated ownership or control.

The companies, management, government regulations and the academia, all are pulling up their socks to find a right formula which could work like a miracle pill, and remove all fears and apprehensions about bad corporate governance practices exhibited even by the most admired companies of the world. Business conglomerates such as Xerox, WorldCom and Enron which were the role models in corporate governance practices were being threatened with widespread exposure of accounting irregularities and

fraudulent corporate governance practices. In today's competitive and piercing environment, the sustainability and goodwill of the organization play a crucial role in winning the customers and other stakeholders for setting up a healthy and profitable ecosystem. The most surprising aspect of the whole story is the reactive approach rather than the proactive approach. Once a scam got exposed or detected, the regulatory watchdogs are ready with an array of rules and regulations to fight against all odds and wrong doing in the corporate world. But once the ailment got over by injecting a fresh dose of bills, rules and regulations we took it for granted that it would not happen again for any wrong reason. This is the destiny of corporate governance practices being written by the most respected and admired companies all over the world.

## 2 Corporate governance in emerging economies

Differ to the conflict of interest between outside shareholders and managers in a diffuse ownership such as that commonly found in the UK and US, the agency problems shifts away to conflicts between the controlling owners and minority shareholders in India and other Asian countries that practice ownership concentration structure (Claessens and Fan, 2002). The concentrated ownership creates agency conflicts between controlling owners and minority shareholders, which are difficult to mitigate through

the traditional functions of board of directors (Fan and Wong, 2003).

It states that the emerging issues in the developed countries is that of disciplining the management who have ceased to effectively accountable to owners (principal – agent conflict) while the problem in developing economies is that of disciplining the dominant shareholders and protecting the minority shareholders (principal-principal conflict). Therefore the study of corporate governance in India requires altogether different approach to tackle the emerging issues in corporate governance practices.

For embryonic firms, the transition to professional management is not an easy task (Daily and Dalton, 1992). Even it is more difficult in emerging economies because of the weak institutional environment. The founder family holds the control through control rights rather than cash flow rights. In essence, these firms attempt to appear as having ‘crossed the threshold’ from founder control to professional management. But the founding family often retains control through other (often informal) means (Liu et al., 2006; Young et al., 2004). Indeed, publicly-listed firms in emerging economies have shareholders, boards of directors, and ‘professional’ managers, which compose the ‘tripod’ of modern corporate governance (Monks and Minnow, 2001). Thus many large cap and even mid cap firms in an emerging economy may have adopted the appearance of corporate governance mechanisms relatively similar to developed economies, but these mechanisms rarely function like their counterparts in developed economies and are more of symbolic nature rather than in true substance.

It seems that corporate governance structures in emerging economies often resemble those of developed economies in form but not in substance and true spirit (Backman, 1999; Peng, 2004). As a result, concentrated ownership and other informal mechanisms emerge to fill the corporate governance vacuum. While these ad hoc mechanisms may solve some problems, they create other, novel problems in the process. Each emerging economy has a corporate governance system that reflects its institutional conditions. It reflects that the convergence of corporate governance practices in emerging economies is in evolving state and each emerging economy should be study in isolation for better understanding of internal and external control mechanisms and their influence on corporate governance practices (Young et al., 2008).

Research on corporate governance in developing economies is now evolving and has recently become a major focus of attention for academics, international organizations and governments. One unique feature of developing countries is that both equity and debt governance plays an important role in the overall governance mechanism. These countries rely much more heavily on banks and equity markets to finance long term projects than developed countries. In this

context the role of lending institutions, the development banks, many of which are government controlled, set the ground as these institutions often hold blocks of equity alongside debt contracts. “Expropriating” behaviour of concentrated owners in the emerging economies is the focal area to be addressed by recent corporate governance literature. It focuses on the structure among owners and conflicts of interests between owners (principal-principal conflict). Watanabe (2010) states that in most developing economies, each listed company has in most cases one concentrated owner or block of shareholders who can exercise influencing power over the management and other minority shareholders. Therefore the friction between concentrated and minority shareholders is the norm of the day. The literature argues that the controlling owner will be able to exert stronger controlling power (control rights) over the decision making of the listed company relative to the size of the shares (cash flow rights) in their hands which is termed as “separation of cash flows and control rights.” Colarossi et al. (2008) proposes three different kinds of board compositions in small family owned firms, crucial for decision making process at the board level.

Indian governance system is sandwiched between Anglo-Saxon governance system prevalent in the US and the UK and the bank dominated systems prevalent in Germany and Japan. It is commonly believed that corporate governance is all about the behaviour of board of directors, executive compensation structures, local laws, market for corporate control and both formal and informal institutions (Walsh and Seward, 1990). But one more important variable which contributes to the effectiveness of corporate governance is firm’s owners. It is an increasingly important and influential group that constitutes both internal and external control mechanisms and governs the actions of managers (Connelly et al., 2010).

In India, the way corporate governance came to be formally adopted by firms especially after 2000 reflects the natural dominance of the contemporary western culture. It has not often been realized that the principles of corporate governance have always been an integral part of Indian culture and society. The fundamentals of corporate governance are way back deep rooted in Indian history. Right from the ancient history, there are multiple incidents to prove the importance of good governance practices. In this context, it would be appropriate to recall the Kautilyan admonition to his King, “In the happiness of his subject lies the King’s happiness; in their welfare his welfare.” (The Arthashastra, Ca.4th Century B.C).

## 2.1 Corporate governance in India: a different cup of tea

Indian governance system is typically a hybrid of the Anglo-Saxon governance system prevalent in the US and the UK and the bank dominated systems prevalent in Germany and Japan. A distinguishing feature of Indian companies which makes it different from its counterparts in the developed world is their high leverage. There is a higher reliance on external sources of financing in Indian companies. Banks and financial institutions (FIs) in India are both lenders as well as equity participants in Indian companies (Dwivedi and Jain, 2005). Some other distinguishing features are—a not so developed equity market and almost non-existent debt market (Goswami, 2000). Business houses and FIs control large blocks of shares in most companies. With a moderately developed capital market, non-existing market for corporate control and weak product market competition, India presents a unique opportunity and challenge to study the behavior of insiders. It is really very strange that the call for better corporate governance practices in Indian soil came from the more enlighten listed companies and an industry association which is further strengthened by the regulatory mechanism. This was quite different from the U.S. or Great Britain, where the drivers of corporate governance were shareholders' group, activist fund and self regulatory bodies within the active capital markets, or in case of Southeast and East Asian countries where it was the result of conditions imposed by the IMF<sup>2</sup> and the World Bank in the wake of financial collapse of 1997-98.

The fallout of some of the reputed and distinguished companies like India's Enron-Satyam has highlighted the fate of corporate governance practices in Indian companies. It has been observed that there is a shift in the approach from value based governance system to rule based system in the wake of most recent and eye opener Indian Enron (Satyam Scam). A debated area of concern in the four walls of the room is that whether we need to inject another dose of major regulatory changes to improve corporate governance practices or it could be achieved through principle based standard of conduct.

In recent years, more and more Indian companies have been raising capital overseas by getting themselves listed on international stock exchanges. These efforts have been accompanied by the Indian government's drive to attract more foreign direct investment (FDI). Both factors have gone hand in hand with the realization that if Indian companies want more access to global capital markets, they will need to make their operations and financial results more transparent. In other words, they will need to improve their standards of corporate governance.

The research on corporate governance has remained in its infancy in India owing to the relatively opaque disclosures practices followed by Indian corporate sector. (Goswami, 2000). Major shareholders

in most of the Indian firms are the business houses, foreign institutional investors, FIs, and Indian public. Public shareholding mainly consists of small individual shareholders who are generally fragmented in nature. The other three types of shareholding are in big blocks. Family supremacy is more overt than covert in Indian corporate houses.

## 2.2 Objective of the study

The present study attempts to investigate the governance practices of small- and mid-cap companies – an area in which little attention has been given and limited data is available. Often companies of all sizes are held to the governance standards and practices of the largest companies are considered as benchmarks for the mid cap and small cap companies as well. These standards, which do not take into account size or industry, may not always be appropriate for all companies. Therefore the current work gives an insight into the corporate governance practices of firms with different market capitalization for comparative study. There is always been an urge to explore that whether the corporate governance practices differ across large cap, mid cap and small cap firms.

A study by Mallin and Yong (1998) in Alternative Investment Market (AIM) reveals that the small cap firms have less emphasis on the formal corporate governance structure. Public companies may be large cap, mid cap or small cap companies face an evolving corporate governance landscape shaped by a combination of factors: greater public attention to governance practices and board oversight; new regulations and proxy statement disclosure rules; emerging of proxy advisory firms and shareholder activism aimed at reforming current practices (Ernst & Young Corporate Governance Center, 2013). The very interest leads the researcher to explore the overall corporate governance of the large cap, mid cap and small cap firms. The study analyses the corporate governance practices of 90 Indian large capitalization (large cap), mid capitalization (mid cap) and small capitalization (small cap) firms listed on the Bombay Stock Exchange (BSE) to compare their corporate governance practices using parametric test.

## 3 Research design

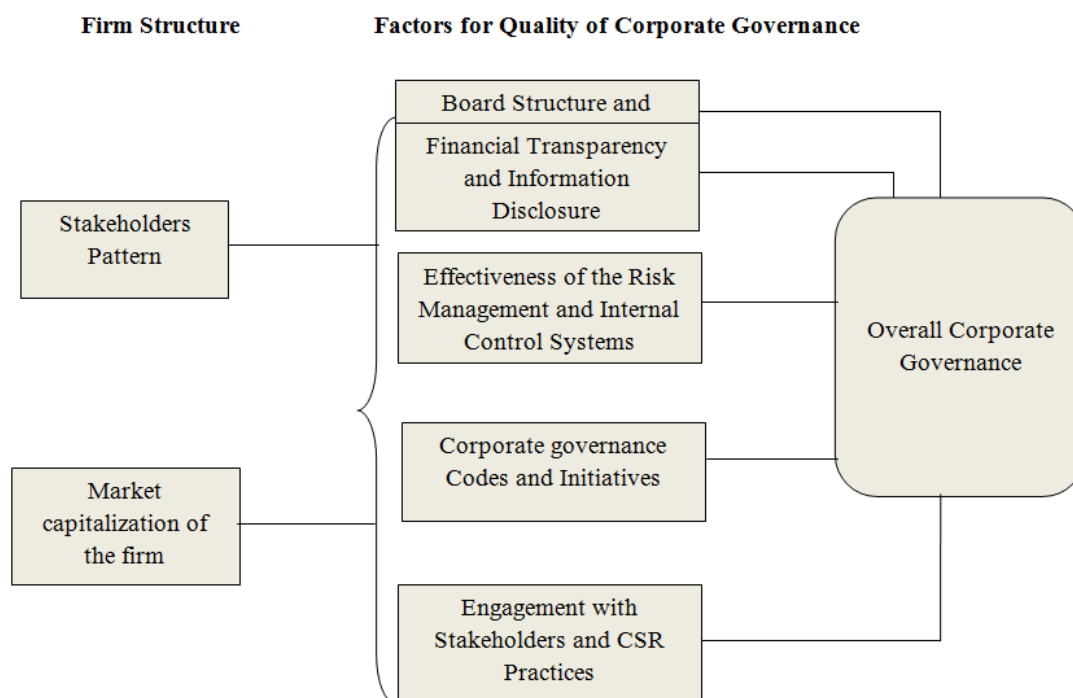
A conceptual governance model of firm performance (Fig. 1) is hypothesized. The model depicts overall corporate governance to be determined by the different factors responsible for quality of corporate governance viz. board structure and process, financial transparency and information disclosure, and other industry and firm level control variables. The model also hypothesizes that the relationship between overall corporate governance and stakeholders patterns may be endogenous as stakeholders' pattern may also affect the overall corporate governance of the firm. The research is a part of an overall plan, where it is intended to develop and test the full model incorporating other board effectiveness variables.

<sup>2</sup> IMF: International Monetary Fund

Companies from each stratum according to their market capitalization have been floated to gauge their corporate governance practices. The study is based on

90 non banking firms listed on the Bombay Stock Exchange for three consecutive financial years 2009-10, 2010-11, and 2011-12.

**Figure 1.** Conceptual framework



The study is based on the variables selected by extensive review of literature on the essential corporate governance components of factors in India and around the globe.

H01: Quality of corporate governance is same among all types of companies irrespective of the market capitalization of company.

In order to accomplish the research objective hypothesis no.1 has been developed. The null hypothesis states that “Quality of corporate governance is same among all types of companies irrespective of the market capitalization of the company.”

One-way ANOVA had been performed to test the null hypothesis that quality of corporate

governance is same among all types of companies irrespective of the market capitalization of the company. The test variable is measured on a ratio scale (corporate governance score), and is grouped by a variable which can be measured on a nominal scale (market capitalization consisting of the categories; large cap, mid cap and small cap).

**3.1 Output of running one-way ANOVA**

We performed a one-way ANOVA, with corporate governance score as dependent variable, and market capitalization as factor, which exists of the groups: 1 = “Small cap companies” 2 = “Mid cap companies” 3 = “Large cap companies”.

**Table 1.** Description (Market capitalization of the firms and quality of corporate governance)

CG_Score								
	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
Small cap companies	30	38.5333	3.72997	.68100	37.1405	39.9261	33.00	47.00
Mid cap companies	30	39.7000	3.94925	.72103	38.2253	41.1747	30.00	46.00
Large cap companies	30	44.0667	4.49470	.82062	42.3883	45.7450	36.00	54.00
Total	90	40.7667	4.68334	.49367	39.7858	41.7476	30.00	54.00

The descriptive Table 1 displays the sample size, mean, standard deviation and standard error for different categories of companies (small cap firms, mid cap firms and large cap firms) at 95% confidence level. The mean score of the respective categories showcase that large cap companies perform fairly better (mean score = 44.06) than mid cap (mean score =39.7) and small cap firms mean score =38.5) in terms of quality of corporate governance. Even the degree of variance is higher in large cap companies (Std. Deviation =4.49) followed by mid cap (Std. Deviation

=3.94) and small cap companies (Std. Deviation =3.72). It showcase that some large cap companies perform fairly better than some other large cap companies followed by mid cap and small cap companies. ANOVA test has been applied by the researcher to further test the significant differences between the mean of different groups.

Before using ANOVA, it is desirable to meet its significant assumption of homogeneity of variance. It has been tested through Levene Statistic.

**Table 2.** Test of homogeneity of variances

CG_Score			
Levene Statistic	df1	df2	Sig.
.525	2	87	.593

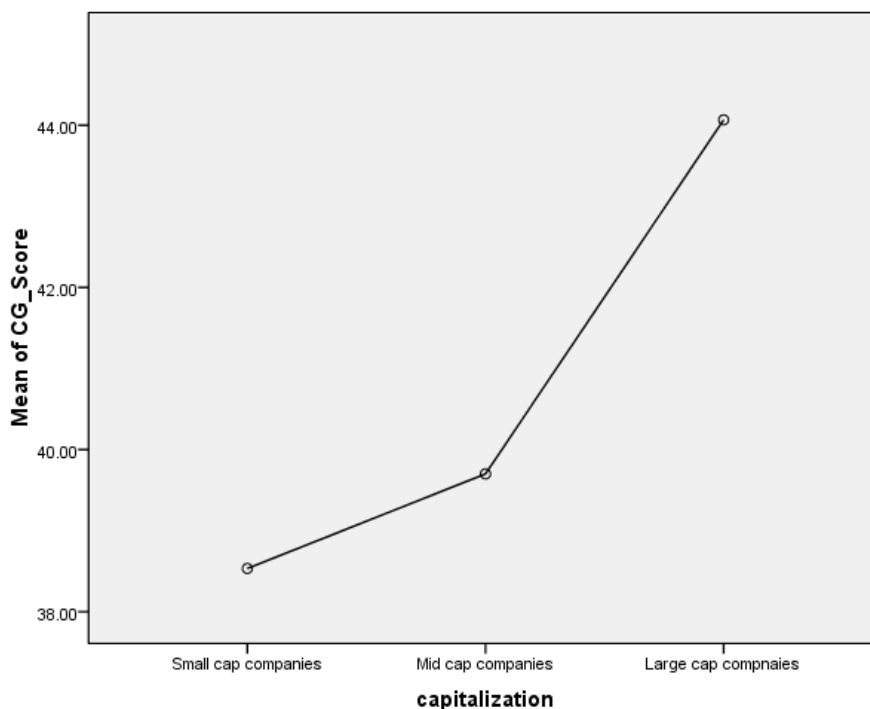
Table 2 showcases ‘Test of Homogeneity of Variances’. Here we find the result of Levene’s Test for Equality of Variances is 0.593 which is higher than the significance value of 0.05; “Sig.” value 0.593

greater than (>) .05. It tests the condition that all groups have similar variances, indicated by the Levene Statistic. It holds the assumption of Homogeneity of Variance (HOV).

**Table 3.** One way ANOVA

CG_Score	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	510.467	2	255.233	15.403	.000
Within Groups	1441.633	87	16.570		
Total	1952.100	89			

**Figure 2.** Mean CG score of different categories of companies



### 3.2 Interpretation

In the Table 3 ‘ANOVA’ the variation (Sum Of Squares), the degrees of freedom (df), and the variance (Mean Square) are given for the ‘within’ and the ‘between groups’, as well as the F value (F) and the significance of the F (Sig.). Sig. indicates whether the null hypothesis – the population means are all equal – has to be rejected or not.

As we can see, there is much difference between the two Mean Squares (510.467 and 1441.633), resulting in significant difference (F = 15.403; Sig. =

0.000). This means that hypothesis could be rejected. Thus we can conclude that the quality of corporate governance differs across large cap, mid cap and small cap firms.

### 3.3 Discussions

One model based on findings has been developed to further showcase the relationship between capitalization of the firms and corporate governance practices.

**Figure 3.** Corporate governance practices of large cap, mid cap and small cap companies



The study of all the factors of corporate governance utilized for the study i.e. Board structure and process, financial transparency and information disclosure, effectiveness of the risk management and internal control systems, corporate governance codes and initiatives, and engagement with stakeholders and CSR practices helps to measure the quality of corporate governance of the respective companies. Based on the above attributes, a final corporate governance scores has been worked out to categorically rate the corporate governance practices of the respective companies. It has been categorized into four categories viz. firms having excellent corporate governance practices, firms having strong corporate governance practices, firms having sound corporate governance practices and firms having weak corporate governance practices.

#### 3.3.1 Excellent corporate governance practice

It includes the firms with excellent corporate governance practices. These are the firms which irrespective of their market capitalization, score maximum on all of the five corporate governance factors used in the study. These are the firms which go

beyond the mandatory guidelines of Clause 49 listing agreements and follow voluntary guidelines of the regulatory mechanisms viz. Securities and Exchange Board of India (SEBI), Ministry of Corporate Affairs (MCA), Confederation of Indian Industry (CII).

#### 3.3.2 Strong corporate governance practices

It includes the firms with sound corporate governance practices. These are large cap firms which are required to comply with voluntary guidelines of the regulatory mechanisms viz. Securities and Exchange Board of India (SEBI), Ministry of Corporate Affairs (MCA), Confederation of Indian Industry (CII) and follow international guidelines and practices viz. Organization for Economic Cooperation and Development (OECD) and others because of their listing on international stock exchanges. These are the firms which follow non-mandatory and voluntary guidelines issued from time to time by different regulatory authorities.

### 3.3.3 Moderate corporate governance practices

These are the mid cap and small cap firms which just comply with the mandatory guidelines as prescribed by the different regulatory bodies.

### 3.3.4 Weak corporate governance practices

These are the firms which irrespective of their market capitalization fail to comply even with the mandatory provisions as stipulated in the regulatory framework of corporate governance in India.

## 3.4 Findings

Public companies may be large cap, mid cap or small cap companies face an evolving corporate governance landscape shaped by a combination of factors: greater public attention to governance practices and board oversight; new regulations and proxy statement disclosure rules; emerging of proxy advisory firms and shareholder activism aimed at reforming current practices (Ernst & Young Corporate Governance Center, 2013). The findings disclose that the quality of corporate governance of large cap companies fairly score better than the quality of corporate governance of mid cap and small cap firms. One reason could be the wide exposure and access of large cap firms to international markets for low cost funds. Tapping into global capital markets to finance their appetite for domestic and international growth, firms from China and India are required to demonstrate strong corporate governance credentials, so that investors do not discount their stock (Porta et al., 2000).

The report further clarify that while some emerging governance trends might be appropriate for larger organizations, smaller companies often face unique circumstances that call for a different approach. Some small- or mid-cap companies may have only recently gone public or they may have investors with relatively large ownership stakes. And smaller companies typically face an array of business issues and challenges that differ from those of larger enterprises. The idea is that the practices that are appropriate for large firms could be ill-suited for small firms. The costs might exceed the benefits for the small firms (Black et al., 2012). Neville (2011) states that the role of board is more important as a resource than its monitoring function in small to medium-sized enterprises (SMEs). It also indicates that good governance appears to be associated with the existence of outside board members.

## 4 Conclusion

The patterns of ownership and control should not only correspond to the needs and characteristics of a particular enterprise but to the “system” prevalent in the country. Firms should have the possibility to move smoothly from one regime to another as they grow and

their needs and constituencies change. Due to convergence of corporate governance practices globally, mid cap and small cap firms are required to strengthen their corporate governance practices. The empirical findings show that there is a significant difference between the corporate governance practices of large cap, mid cap and small cap firms.

Black, Carvalho and Gorga (2012) recommends that it could make sense to adopt “across the board” rules and regulations for uniformity and convergence of corporate governance principles both within and across countries. A growing consideration of stakeholder interests is viewed increasingly as a key growth factor in the long term value of companies. In multinational companies, stakeholders come from many different countries. The emergence of unified strategies to deal with these issues across national boundaries is in itself another driver of convergence. More cross-border equity investment and the growth of domestic and international market institutions should be expected to result in a better mutual understanding between overseas investors and companies and consequently in an increased capacity for companies to access international sources of finance. The study suggests that the mid cap and small cap firms should strive to benchmark their practices against the practices of large cap firms in order to win confidence of the market, investors and the society.

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