

AN EMPIRICAL EXAMINATION OF THE IMPACT OF CORPORATE GOVERNANCE DISCLOSURE ON FINANCIAL PERFORMANCE

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Abstract

The Indian corporate governance relationships have evolved over time as a result of both formal and informal stakeholder interactions, with changes to Clause 49 triggering a further evolutionary move in Indian corporate governance towards global benchmarks. This study seeks to gain insights into how the regulatory changes impacted corporate governance (CG) practices in India by measuring their effect on performance. We construct a "CG Compliance Index" using three important governance mechanisms for the year 2008. The analysis reveals that majority companies have complied by the regulations depicted by high CG compliance score and have a significant positive relationship between CG Compliance Index and the market measure of financial performance of companies.

Keywords: Financial Performance, Corporate Governance Compliance Index, India

JEL Classification: G18, G34

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1 Introduction

Corporate Governance has assumed importance since the emergence of the limited form of corporate business organizations, but its reference in academic literature began towards the end of the 20th century. The aftermath of financial scandals (e.g. Poly Peck, BCCI and pension funds of Maxwell Communication Group in the U.K.) triggered the need for governance reforms and consequently Cadbury (1991) attempted to provide guidelines for the best corporate governance practices. This Cadbury Committee report prescribed a series of codes on corporate governance practices. Later, many other committees were appointed by different countries of the world including U.K., South Africa, Malaysia, Japan, Germany, France, Pakistan and India for prescribing good governance practices. Some notable foreign committees are:

- Greenbury Committee Report (U.K.) – 1992
- King Committee Report (South Africa) - 1994
- Vie'not Report (France) – 1995
- Hampel Committee Report (U.K.) – 1995
- Combined Code of London Stock Exchange (U.K.) – 1998
- Investors' Principles of Board Corporate Governance (O.E.C.D., Europe) – 1999
- Higgs Report (U.K.) – 2003
- Smith Report (U.K.) – 2003

In the aftermath of a series of corporate failures like Enron, Tyco, Adelphia, Xerox and WorldCom, the Corporate America felt its existing control mechanism not to be sufficient to tackle the problem. Hence a more stringent set of rules has been imposed in Corporate America. These include Sarbanes Oxley (SOX) Act (2002), NYSE Listing Standard (2003) and SEC Listing rules (2003). India also prescribed codes after major financial scams starting from Harshad Mehta Scam in 1992 to UTI fiasco to Ketan Parekh scam in 2001 and the Satyam Saga recently. These important codes have been collated in Exhibit 1.

Accepting the recommendations of Kumar Mangalam Birla Committee (1999), the Indian regulator - Securities and Exchange Board of India (SEBI) advised all stock exchanges to amend their listing agreements by inserting clause 49. This clause gives a comprehensive list of good corporate governance practices and is applicable to both public and private sector companies. On October 29, 2004, clause 49 was revised and the revised clause 49 came into being. The provisions of revised clause 49 are required to be implemented by companies complying with the existing clause 49 by 31st March, 2005. The deadline for the compliance of revised clause was later extended to 31st December, 2005.

In India the initial impetus for corporate governance reform was driven by the private sector, which was keen to make Indian business more

competitive and respectable in the global markets. The Confederation of Indian Industries (CII) published a voluntary Code of Corporate Governance in 1998. SEBI followed this initiative by setting up the Birla Committee on Corporate Governance, and its December 1999 recommendations formed the basis for Clause 49 of the SEBI Listing Agreement. The Birla committee recommendations sought guidance from the 1992 Cadbury report in the UK and, as a consequence, India adopted key planks of an 'international best practice' code. SEBI revised Clause 49 introduced in the late 2004, with the revisions to the independence of the chair and proportion of independent directors coming into effect from 1 January 2006.

Similar to the United Kingdom (UK) and the United States (US), the Indian regulations focused on the role of the board as a bridge between owners and the management. The committee recommendations leading to Clause 49 suggest that in India the influence of concentrated and controlling shareholders is immense. Thus, the presence of majority independent directors on the board as suggested by the amended Clause 49 seeks to moderate this particular influence.

Since 2006, listed companies are required to submit quarterly compliance reports to the SEBI, similar to those required in the US by Sarbanes-Oxley. However, enforcement of compliance remains an issue due to the relatively weak legal framework. While still an emerging economy, India is pre-eminently a common law country with a well-developed system of law and justice. However, while there is a good foundation of law, critics argue that the legal and judiciary system moves too slowly. Enforcement of Clause 49 falls to the SEBI. With over 6000 listed companies, monitoring and enforcement are significant challenges in the immediate term. While SEBI's ultimate sanction in cases of serial non-compliance is delisting, this is unpopular as delisting penalizes the non-controlling dispersed shareholders and closes their exit options.

Hence, SEBI has tended to enforce the recommendations through dialogue and in some cases monetary penalties. While the incidence of monetary penalties has been reported, the names of the non-complying companies have not been disclosed, suggesting that this action acts more of a signal for non-compliant companies to mend their ways. While the effectiveness of enforcement of the framework remain an interesting empirical question, the corporate governance framework established is robust and in principle as effective as those of the UK and US and in many areas superior to continental European and other emerging markets, in view of many commentators (for e.g. Grant et al., 2007; and Institute of International Finance, 2006). Critics argue that India is behind countries like Singapore and Hong Kong in terms of some governance parameters as stated by Kaufmann et al., (2008).

However, despite the support and criticism of the new framework, there is no dispute about the importance of corporate governance in India. Early evidence suggests that the new regulatory regime is working. For example, a recent study by Black and Khanna (2007) found that firms' market value increased with corporate governance reforms. This suggests that despite slow regulatory enforcement, the financial market rewards companies with good governance.

2 Literature review

The composition of executive and non-executive directors was highly debated by the researchers. One school of thought believes that executive insiders play an important role as they have specialized knowledge and expertise about their organization that comes from their personal experiences. This presence can enhance top management commitment and willingness to pursue risky, though potentially successful, development activities and investment plans. Others strongly feel that independent directors play a crucial role in facilitating the acquisition of resources needed by firms to reduce operating uncertainty and to survive and function effectively. They are important because of greater breadth of knowledge and experience they bring with them from external sources.

A number of studies have examined the relationship between the composition of board of directors, defined in terms or ratios of either outsiders or insiders to the total number of board members, and the performance of the firms. Although the issue is debatable, various conceptual analyses suggested that a firm's board of directors contributes to the process of corporate governance by selecting and evaluating the firm's chief executive officer (CEO) and other top managers, shaping the firm's strategic direction, setting corporate productivity objectives, and assessing business success. Some or all of these governance activities have discernible effects on the firm's performance.

Fama and Jensen (1983) for example, argues that outside directors provide enhanced value by providing advice to the CEO, due to their specific expertise and connections. As such, a larger board with a higher proportion of outsiders should improve quality of information available on the firm's investment options as highlighted by resource dependency proponents. Consistent with this viewpoint, regulators have targeted insider / outsider board composition as a key concern, advocating that boards of directors should be controlled by outside directors, not by insiders who might compromise the interests to the concerns of managers.

An increasing amount of international evidence is now emerging on a number of corporate governance issues relating to board structure and corporate performance. Corporate excellence and

good governance are so intertwined that achieving one without the other is unimaginable. Well-governed companies produce distinctively excellent performance. Good corporate governance is a source of competitive advantage and critical to economic and social progress.

Irrespective of difference between various forms of corporate governance, all forms recognize that good corporate practices are must and – at the very least – satisfy two sets of claimants; creditors and shareholders (Goswani et al., 1996)

A recent study conducted by the Organization for Economic Corporation & Development (OECD) explains that non-financial performance data is relevant to the shareholder's evaluations and investment decisions. Corporate governance is now the focus area and the performance of companies on this front is under close scrutiny. There have been several regulatory developments regarding corporate governance and the implementation of the revised clause 49 of the listing agreement will have to be complied with from the end of April 2005.

According to a recent study conducted by Ward et al., (1999), "A company's bad stock performance was more likely to correlate with board departures. Secondly directors who lost their jobs, as CEO's were significantly more likely to leave other company boards as well. Interestingly, poor performance seemed to have nothing to do with it. Invitations to join boards seem to come through connections rather than demonstrated merit in running firms."

In the western context there were many research studies that have been based on methodology that links elements of board structure to financial measures of corporate performance or to a single corporate event. These studies focused on whether the percentage of non-management directors on a board correlated with frequency of CEO replacement, response to takeover bids, or variations in stock prices. Their results disagreed in their statistical significance and, in some cases, even on the positive or negative character of the relationship. This inconclusive relationship warrants a detailed research in this area in Indian context.

Chatterjee (2009) in "Independent Directors – An Indian Legal Perspective" critically analyzes the role and effectiveness of independent non-executive directors especially in the light of Higgs Committee Report in U.K. He finds that India lacks the selection procedure for independent director. He recommended the adoption of Narayan Murthy Committee's view with respect to the tenure of independent director limited to 9 years. He also suggested that Independent director should play the role of an auditor.

Prasanna (2006) investigates empirically influence of independent board on firm's value. His empirical analysis did not produce evidence on the same due to short period of study and non clarity of director's being independent in Indian Context. He suggested that nominee directors should not be

deemed as independent directors and asserted that attitudinal change is needed towards independent directors; otherwise they would be independent by definition but not in practice. Morck (2004) stated that corporate governance disasters could often be averted had directors asked their CEOs questions, demanded answers, and blown whistles.

Patton and Baker (1987) stated that this non-executive director may not be able to understand each business well enough to be truly effective but can bring a wide functional, product or market knowledge of different industries and companies to the board. In addition, they often have external contact, which enables them to enhance management's ability to secure scarce resources and to align the external environment. They represent change agents and bring new perspectives. Klein (1995) examines the administrative structure of a board through committee structures. She finds a positive relationship between the percentage of outsider and the factors associated with the benefits of monitoring.

Wagner and Fubura (1998) present two studies that examine the commonly held belief that corporate boards are more likely to have effects on organizational performance when composed of outside directors. The first study – a meta-analysis of 63 correlations – indicated that, on average, the greater presence of outsiders is associated with higher performance, but so too is the greater presence of insiders. Instead of providing evidence of a positive outsider effect, these results suggested the existence of curvilinear homogeneity effect in which performance is enhanced by the greater relative presence of either inside or outside or outside directors. The second study – a hierarchical polynomial regression analysis of data from 159 large US companies – confirms the existence of curvilinear relationship between insider / outsider composition and performance measured in terms of return on assets.

Barnhart and Rosenstein (1998) examined sensitivity of simultaneous equations techniques in corporate governance research. They adapted Tobin's q model composition and managerial ownership and investigated the combined effects of ownership structure and board composition on corporate performance, using an instrumental variables approach. The evidence indicated that inside ownership, board composition, and firm performance are jointly determined. Gupta (2007) survey of the early 1980's found that the nominee director's presence had brought about some formality and openness to board practices. Bansal (1989) found that boards with non-executive directors usually shift from family boards to professional ones.

Bhagat and Black (2002) found no correlation between the board independence and long term performance among the largely traded American companies. Yermack (1996) reports a significant negative correlation between the proportion of

Independent directors and contemporaneous Tobin's q which is the ratio of market value of firm's assets to book value of its assets. Klein (1998) also reports the negative correlation between a measure of change in market value of equity and proportion of Independent directors. Cotter and Silvester (2003) found no positive relationship between board, governance committee independence and firm value. Rosenstein and Wyatt (1997) found that the stock prices increase by about 0.2% on an average, when a company appoints an additional outside director and commented that this increase is statistically significant but economically small to reflect the signaling effects.

The discussion paper brought out by the Confederation of Indian Industry emphasizes that good non-executive directors can make a positive contribution to the organization. It is of paramount importance that they should bring an independent judgment to key issues such as strategy, performance, resources, key appointments and standards of conduct. Non-executive directors should become active participants in boards and not be passive advisors. Board composition has been subject of extensive research as a determinate of company performance and research provided evidence that the ability of boards to perform their strategies, governance and institutional functions depends largely on their composition.

However there is no general consensus explaining the link of variations in board size and the type of membership with company performance. This lack is attributable to the presence of "unidirectional, casual relationships" between corporate financial performance and board composition.

There is a shift in Corporate Governance reforms from non-executive director to Independent directors. Over the last 5 years, corporate boards have undergone a gradual but dramatic change. Today most of the board consists of majority (70%) non executive directors. The regulators are consciously monitoring and consistently requiring the presence of Non-Executive Independent Directors on the boards. Coupled with the trend, the researchers are also working on the effectiveness of independent board. Therefore we hypothesize that there is a positive relationship between financial performance and corporate governance in Indian companies.

3 Research design

3.1 Data

This study considers data for CNX Nifty 50 companies. The CNX Nifty is a well diversified 50 stock index accounting for 23 sectors of the economy. However, the study excludes banking and financial companies. Corporate Governance Report of NSE listed companies available from Prowess database developed, maintained and marketed by CMIE forms the principal data source. However, in some cases, to

confirm the observed data and to collect additional data, the companies' websites have also been visited. For our study, the post-implementation period of clause 49 of the listing agreement of SEBI of a single year i.e. the year ending on 31st March, 2008 has been considered.

3.2 Variable

3.2.1 Dependent variable

3.2.1.1 Financial performance (FP)

We use return on assets as a measure of operating performance. Substituting other measures of operating performance such as gross profit margin and return on equity gave similar results. A higher ROA indicates effective use of companies' assets in serving shareholders' economic interests. This performance indicator has also been used in previous studies on firm performance (Daily et al., 1999 and McConnell and Servaes, 1990).

3.2.2 Independent variable

3.2.2.1 Corporate Governance compliance index (CGI)

Corporate Governance compliance index was calculated using three parameters, namely Board Practices, Accounting Policies and Transparency and Disclosures. Then percentage of Compliance index was calculated giving equal weights to all three parameters. The index constituents are listed below.

1. Board Practices
 - No. of Independent Directors
 - Independent Directors in Audit Committee
 - Finance literate chairman in Audit committee
 - Independent Chairman of Audit committee
2. Accounting Policies
 - Any P& L entries made directly in the balance sheet
 - Any significant intangible asset/goodwill on its balance sheet
 - Does the company actively deal with derivatives/other financial market instruments
 - Any other significant departure from conservative accounting
 - Any qualification from auditors in last annual report.
3. Transparency and Disclosure Index
 - Material related party transactions for the company
 - Disclosure of financials of key subsidiaries on a regular basis (Annual)

On the basis of disclosures requirements of corporate governance, a check list was prepared. On the checklist, each item was coded as 1 if disclosed; and 0 if not disclosed and NA if not applicable.

CI: Compliance Index was computed by dividing total no. of disclosures made with total no. of disclosures applicable. Each item of disclosures was given an equal weightage.

3.2.3 Control variables

We recognize the difficulty of adequately modeling firm performance and thus control for firm size (measured by natural logarithm of sales).

3.3 Methodology

Ordinary least square regression is utilized for testing the model. Estimation is conducted with White (1980) heteroskedasticity-consistent standard errors. Figure 1 illustrates the research design of the study.

Figure 1. Research design

Data	Sample	CNX Nifty 50 companies
	Source	Prowess
	Period	March 31st 2008
Variable	Dependent Variable	Financial Performance
	Independent Variable	Corporate Governance Compliance Index
	Control Variable	Firm Size
Methodology	Ordinary Least Square Regression	

4 Empirical model and results

The following empirical model is specified for testing the impact of governance disclosure requirement on financial performance.

$$FP = \alpha_0 + \beta_1 CGI + \beta_2 FS + \varepsilon \quad (1)$$

where

α_0 Intercept

FP Financial performance measured by return on asset

CGI Corporate Governance Compliance Index

FS Firm Size measured by natural logarithm of sales

4.1 Empirical results

Table 1. Summary statistics

Variables	Descriptive				Correlation		
	Mean	S.D.	Min	Max			
FP (Rs. crore)	13.97	7.85	1.04	35.25	1.00		
CGI (%)	77.88	14.61	54.54	100	0.37	1.00	
FS (Rs. crore)	11.54	1.60	4.41	14.14	0.19	0.09	1.00

The above table 1 shows the highest level of compliances is 100% whereas lowest is 54.54%. On an average, financial performance measured by ROA is 13.97 ranging from 1 to 35 (Rs. crore) approximately.

The results (see table 2) indicate that CGI is significantly affecting ROA at 1% level whereas firm size has no impact on the accounting measure of performance.

disclosure on financial performance taking a case of select large listed Indian companies. Corporate governance disclosure index was created by utilising three important governance mechanisms namely board practices, accounting policies and transparency and disclosures. The study found that the companies have shown high degree of compliance with disclosure requirements of Corporate Governance and is significantly affecting the financial performance of the company.

5 Conclusion

This study attempted to conduct an empirical examination of the impact of corporate governance

Table 2. Regression results

Dependent Variable: ROA	
Constant	-9.10 (-1.10)
CGI	0.18 (2.78)**
FS	0.76 (1.27)
R SQUARE	16%

Note: * Significant at 1% level

Notwithstanding the findings, the present study suffers from the following limitations, which would possibly represent opportunities for further investigation. Firstly, the study is based on data for a single year (i.e., 2008-09). Future researchers can conduct a longitudinal studies for understanding the long term policy implications. Second, the present corporate governance compliance index is composed of three parameters which can be extended to include aspects such as risk management, internal controls and qualitative aspects such as education and experience of the board. Future studies can conduct comparative studies on the degrees of compliance by private and public sector companies with longitudinal data. This relationship can be tested with both accounting and market based financial performance measures.

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