CHAPTER 6: IMPACT OF CG DISCLOSURE ON THE PERFORMANCE OF SELECT PSUs IN INDIA

6.1 INTRODUCTION:

Corporate Governance (CG) takes into account number of aspects such as, enhancement of shareholder value, protection of shareholder’s rights, composition and role of the Board of Directors, integrity of accounting practices and Disclosure norms and internal control system. Among all these aspects Board Composition and Disclosure is given more importance as it helps in increasing shareholders value and protection. Board Composition was discussed in chapter 5 and in this chapter 6 Disclosure is focused. The increased Disclosure requirements are the response to the recent Corporate Governance failures like Satyam, Enron, and WorldCom etc that hit the headlines. (Ballas et al., 2008) found that increased Disclosure is perceived as better governance because Disclosure enables better decision making by the players in the capital markets. In India, the Corporate Governance Disclosure norms are issued by SEBI (Securities Exchange Board of India) under Clause 49 of the Listing Agreement which was revised and issued on October 29, 2004. The Corporate Governance structure describes the allocation of the responsibilities and rights of various corporate participants like managers, directors, shareholders and other stakeholders. It brings out

the procedures, rules and regulations needed to follow for important corporate affair decisions.

Given the separation of ownership from management, the directors/auditors are required to reflect the independence of their appointments in the company through their reports, responsibility statements and other financial statements, which are annually sent to the shareholders and regulatory authorities.

The accounting policies and standards adopted are the backbone of the entire Corporate Governance framework like for a scrutiny of financial affairs of the corporate entity, it is the auditors’ report that shareholders rely on for greater transparency and Disclosures. The accounting and audit mechanism should provide for necessary checks and balances for an external user and help in making more informed decisions.

Successful attempts are being made by regulatory body to ensure that companies adopt good Corporate Governance practices (Khan, 2006). For improving Corporate Governance, the government and regulators plays a very important role. They strengthen the laws that protect shareholder’s interests and ensure the enforcement of such laws and regulations. In comparison to the other developing countries in Asia, the quality of the Indian Corporate Governance system is found to be good. The Indian Corporate Governance norms are developed based on
the British model, which is one of the good models, but the enforcement of securities law in India is poor.

To achieve the optimum level of investor confidence, the corporate leaders need a set of tools that provide greater visibility into their organizations and strengthen Corporate Governance (Jhunjhunwala and Pandey, 2008). Good governance can improve the public faith and confidence in the organization. It can enhance wealth creation, ensuring the efficient management of wealth and equitable distribution of wealth among all shareholders. It is the foundation to build market confidence and encouraging stable and long-term foreign investment flows.

**6.2 IMPORTANCE OF THE STUDY:**

This chapter helps in understanding the affect of Disclosure on firm performance in the market. The various researchers have different point of view on Disclosure based on their research as follows:

Disclosed information serves to reduce the unfavorable effects of moral hazard and adverse selection by the players of capital markets first regarding the firm itself and then of the management team. The firms would disclose relevant information as fully as possible, especially when there are applicable legal requirements, to avoid adverse selection (Grossman, 1981). (Patel et al., 2002) develop a model to measure transparency and Disclosure of firms in emerging markets. A commonly cited benefit of Disclosure is that by mitigating uncertainty, Disclosure may reduce the magnitude of the impact of news about a firm's
performance, which would reduce stock price volatility (Lang and Lundholm, 1993), (Bushee and Noe, 2000). (Sengupta, 1998) found a positive association between quality of corporate Disclosure and bond ratings. (Ajinkya, et al., 1999) found a positive relationship between financial analysts’ ratings of corporate Disclosure practices with institutional stock ownership. According to (Diamond, 1985), the Disclosures result in greater improvement in welfare because they reduce investors’ need to search privately for information which has substantial costs.

From a theoretical perspective, managers have the incentive to disclose information that justifies the continuation of the business and their own earnings. The empirical evidence suggests that levels of corporate Disclosure are positively related to performance, quantified on the basis of the return on equity (ROE) (Meek et al., 1995), (Ettredge et al., 2002), (Haniffa and Cooke, 2002).

As per the survey by (Healy and Palepu, 2001) there is no unambiguous theoretical framework regarding corporate Disclosure supply and specifically about the effects of regulation of corporate communications, despite of Corporate Disclosures playing a cardinal role in financial markets. Apart from this, there has been limited direct empirical evidence on the costs and incentives of corporate Disclosures.
(Milgrom, 1981) show negative effect of Disclosure on firm performance as companies would act strategically and disclose favorable items and suppress unfavorable ones, especially when such items affect managements’ remuneration and, generally, the managers’ position in the market for managerial talent. (Verrechia, 1983 and 1990) demonstrated that the incentive to disclose information is a decreasing function of the potential, negative, effects of the Disclosure on the firms’ future cash-flows. Thus, non-Disclosure should not necessarily be interpreted as bad news because it may be a favorable item whose Disclosure would negatively affect the firm’s future cash-flows. Thus, the non-Disclosure is a positive action by the firm’s management. The model developed by (Darrough and Stoughton, 1990) predicts that firms that have less fear of potential entrants in their markets are more likely to respond to market demands for information.

Disclosure may reduce heterogeneity of values and beliefs about the real Firm Value. It may thus reduce both the volume traded and the volatility of the stock price (Diamond and Verrecchia, 1991). Economic theory and evidence (Diamond and Verrecchia 1991), (Leuz and Verrecchia, 2000) suggest that the amount of Disclosure that a firm provides depends on its size as well as on the need for external funds. (Beiner, et al., 2006) show that, across countries like Germany and Switzerland, companies with better governance and Disclosure have higher measures of Tobin’s q. They find a significant and positive
relationship between the quality of firm Corporate Governance and equity market valuation.


In the U.S., researchers have also observed the adoption of mandatory Disclosure rules. (Oyer, et al., 2005) report evidence that the 1964 extension of mandatory Disclosure requirements to large NASDAQ firms predicts positive returns to firms that had not previously voluntarily met the Disclosure requirements, (Ferrell, 2004) reports that this extension reduced share price volatility.

(Klapper and Love, 2004) analyzed the firm data for over 400 companies in 25 emerging economies to show that good Corporate Governance practices and Disclosure of the same were highly correlated with firm market valuation and found that firm level Corporate Governance practices tend to be worse in countries with poor legal protection.

(Raja and Kumar, 2008) found that the Corporate Governance practices in the Indian service firms have positively influenced the firm performance. The CG score has found good reception by the national and international financial community, especially in emerging countries.
Such systems will provide a useful benchmark for the majority of investors who identify good CG with a well-run and well-managed company (Bhasin, 2009). Corporate Governance is seen as the appropriate mechanism to regain the confidence of players in order to build up the market and economy (Ariff et al, 2007). The Kumar Managlam Birla Committee Report\(^8\) acknowledges that the fundamental objective of Corporate Governance is, “the enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders.”

Thus Corporate Disclosure is an essential element of well functioning markets including both the capital markets as well as the market for managerial skills, markets for goods and services etc. and good performers are more willing to disclose quality information as it generates positive image of firm performance on the capital market and investors.

Firms disclose information to the capital market both through regulated financial statements i.e. annual reports and ad hoc voluntary communications such as their Internet sites, newspapers i.e. press releases and so on. In addition, one can locate Disclosures about a firm made by third parties such as brokerage houses and the financial press.

\(^8\) [http://www.sebi.gov.in/commreport/corpgov.html](http://www.sebi.gov.in/commreport/corpgov.html)
6.3 OBJECTIVE OF THE STUDY:

The objective of the present study is to examine the impact of Disclosure component score of Corporate Governance framework on the performance of select public sector companies.

6.4 HYPOTHESIS:

It is hypothesized that CG Disclosure score has a positive impact on the performance of Public Sector Undertakings (PSUs).

6.5 RESEARCH METHODOLOGY

The Corporate Governance Disclosure scores for each company were manually computed as per the Disclosure guidelines issued by Securities Exchange Board of India (SEBI) from the Annual Reports of the companies. The summary of guidelines regarding transparency and Disclosure issued by SEBI under Clause 49 of the Listing Agreement is presented in Annexure I B.

The detail research methodology for the present chapter is as follows:-

6.5.1 DATA COLLECTION: Research data can be collected from both primary and secondary data source. However, in the present study secondary data has been extensively used. Secondary data has been collected from the annual reports of the respective companies and Prowess, a financial data base of Centre for Monitoring Indian Economy (CMIE).
6.5.2 SAMPLE SELECTION CRITERIA:

The total number of companies in India is divided into two categories that are listed and non-listed companies on leading exchanges like BSE/NSE. Among the total number of companies, it is found that there are 5134 listed companies and remaining all companies is not listed on BSE/NSE. The Bombay Stock Exchange (BSE) which is one of the leading stock exchange of India from February 2008, has classified Equity scripts into various categories such as A, B1, B2, S, T, TS, & Z to provide assistance to the investors. The classification is based on a number of factors such as market capitalization, trading volumes and numbers, track records, profits, dividends, shareholding patterns, and some qualitative aspects. In the present study Group 'A' companies are selected as it is the most tracked class of scripts consisting of about 200 companies out of which 50 companies are even listed on Nifty 50 Index. From the total of 50 companies only 9 companies belong to public sector and remaining 41 companies are from Private sector. The main factor for classifying companies into group 'A' category is market capitalization. From this list top five best performing companies from public sector was taken, where the performance was measured by Market Capitalization.
6.5.3 PERIOD OF THE STUDY: The study is covered over a period of five year and the data has been collected on annual basis i.e. for the purpose of analysis, the data was collected for five respective years i.e. 2004-05, 2005-06, 2006-07, 2007-08 and 2008-09.

6.5.4 ECONOMETRIC MODEL

There are several econometric analyses available such as time series analysis, cross-sectional analysis etc but in a time series analysis, one can measure the impact across time period and in cross-sectional analysis, one can measure the impact across the firms. For the present study Panel data analysis was implemented for examining the impact of CG Disclosure on the performance of the Public Sector Undertaking's as it can be used to measure the impact across the time period and across the various firms together. A panel is a cross-section or group of people who are surveyed periodically over a given time span. The combination of time series with cross-sections can enhance the quality and quantity of data in ways that would be impossible using only one of these two dimensions (Gujarati, 1999).

In the present study Panel data analysis is used to find out the influence of independent variable i.e. Corporate Governance Disclosure on dependent variables i.e. Firm Performance (proxy by Market Capitalization) and Dividend Payout ratio, Firm Value, Growth in Sales, Leverage and Net Profit Margin are considered as the controlled variables. Each of these variables is assumed to have a positive impact
on performance of sample companies taken in the present chapter. There are various models of panel data analysis as discussed in earlier chapters but for the present objectives, Robust Random-Effect GLS Regression model of panel data analysis is considered.

6.5.5 MODEL SPECIFICATION

In panel data analysis the first important step is to set up the model for the use of the same in ‘STATA’ statistical package. Robust Random-Effect GLS Regression models with “firm” and “year” effects is applied to analyze the determinants of firm performance as measured by Market Capitalization as shown below:

\[
Y_{it} \text{ (Market Capitalization)} = \alpha + \mu_i + \lambda_t + \beta X_{it} + \varepsilon_{it}
\]

Where \( I = 1, 2\ldots n \) (number of firms) and \( t= 1, 2\ldots T \) (number of years). Here \( Y_{it} \) is the dependent variables i.e. Market Capitalization respectively and \( X \) is the vector of explanatory variables i.e. \( X_{it} \) is the vector of independent variables for \( i^{th} \) company for the time period \( t \), \( \beta \) is the vector of regression coefficients, \( \varepsilon_{it} \) represents the disturbance term, \( \mu_i \) represents the firm effect and \( \lambda_t \) represents the year effect. It is assumed that the errors \( \varepsilon_{it} \) follow a normal distribution is \((0, \sigma^2)\) for all \( 'i' \) and \( 't' \) in the model. This implies that the errors are serially uncorrelated and homoscedasticity exists. The term \( \alpha + \mu_i \) is the intercept for firm \( 'i' \). Similarly, \( \alpha + \lambda_t \) is the intercept for the year \( t \). In this random effects model, estimates of the slope parameters are based on within group (firm-year) variation and between groups variation is ignored.
The correlation matrix was also drawn to understand the relationship among the independent, dependent and controlled variables. The econometric model for testing the hypothesis developed to examine the Corporate Governance Disclosure and its impact on market capitalization of the select public sector undertakings (PSUs). The model for measure of impact of Corporate Governance Disclosure score on Market capitalization is presented below:

\[(\text{Market Capitalization})_{it} = \alpha + \mu_i + \lambda_t + \beta_1 (\text{Corporate Governance Disclosure})_{it} + \beta_2 (\text{dividend payout ratio})_{it} + \beta_3 (\text{Firm Value})_{it} + \beta_4 (\text{growth in sales})_{it} + \beta_5 (\text{Leverage})_{it} + \beta_6 (\text{Net profit margin})_{it} + \beta_7 (\text{Market Capitalization})_{it-1} + \varepsilon_{it}\]

6.5.6 DESCRIPTION OF VARIABLES:

6.5.6.1 DEPENDENT VARIABLE: In the present study, the performance of the company was measured based on market capitalization. The average market capitalization of equity was calculated by multiplying quarter end closing price of each share with outstanding number of equity shares.

6.5.6.2 INDEPENDENT VARIABLE: In India, it is mandatory for all the listed companies to present their Annual Reports as per the Disclosure norms given by SEBI under Clause 49 of the listing agreement. In the present chapter CG Disclosure scores were computed based on the "Revised Clause 49 of the Listing Agreements" issued on October 24,
2004. The summary of the list of provisions is presented in Annexure IB.

6.5.6.3 CONTROL VARIABLES: In this study, based on the extant review of literature for measuring the impact of CG Disclosure on Market Capitalization, the Dividend Payout Ratio, Firm Value, Growth in Sales, Leverage and Net Profit Margin are considered as the controlled variables. Each of these variables was assumed to have a positive impact on market performance of select public sector companies. The description of controlled variables is presented in Exhibit 6.1.

**Table 6.1: Description of Controlled variables**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend Payout Ratio</td>
<td>Measured by percentage of dividend per share divided by earnings per share</td>
</tr>
<tr>
<td>Firm Value</td>
<td>Measured by market capitalization plus book value of debts divided by book value of total assets</td>
</tr>
<tr>
<td>Growth</td>
<td>Measured by growth in sales</td>
</tr>
<tr>
<td>Leverage</td>
<td>Measured by percentage of total debt to total assets</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>Measured by Profit after taxes</td>
</tr>
</tbody>
</table>

6.5.7 SCOPE OF THE STUDY: The scope of the present chapter is limited to the analysis of Corporate Governance Disclosure and performance of select public sector companies drawn from the Bombay
Stock Exchange (BSE) for a period of 5 years that was from 2004 to 2009.

6.5.8 LIMITATIONS OF THE STUDY: In the present chapter, public sector companies were drawn only from the Bombay Stock Exchange (BSE) which is even listed on national stock exchange for a period of only 5 years that was from 2004 to 2009. The study was limited to only public sector companies' Disclosure practices.

6.6 RESULTS AND ANALYSIS

The study of Corporate Governance Disclosure and its impact on the Market Capitalization of the select public sector undertakings (PSUs) indicate the following results:

Table 6.2 shows the pooled sample descriptive statistics with mean, standard deviation, minimum and maximum of continuous measures used in the panel data regression analysis.

Table 6.2: Pooled Sample Descriptive Statistics

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Stan.Dev</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG score</td>
<td>74.850</td>
<td>10.574</td>
<td>51.000</td>
<td>90.000</td>
</tr>
<tr>
<td>MarketCap</td>
<td>37931.328</td>
<td>43617.804</td>
<td>729.260</td>
<td>158471.700</td>
</tr>
<tr>
<td>DivPayment</td>
<td>0.243</td>
<td>0.167</td>
<td>0.000</td>
<td>0.522</td>
</tr>
<tr>
<td>NetProfitMargin</td>
<td>2381.453</td>
<td>2310.807</td>
<td>-443.400</td>
<td>7414.800</td>
</tr>
<tr>
<td>Leverage</td>
<td>0.287</td>
<td>0.352</td>
<td>0.000</td>
<td>1.151</td>
</tr>
<tr>
<td>Growth</td>
<td>-0.513</td>
<td>3.010</td>
<td>-13.291</td>
<td>0.399</td>
</tr>
</tbody>
</table>
The correlation matrix is presented in the following table 6.3 to understand the relationship among the independent, dependent and controlled variables.

**Table 6.3: Correlation Matrix**

<table>
<thead>
<tr>
<th></th>
<th>CG Scores</th>
<th>Div Payment</th>
<th>Firm Value</th>
<th>Growth</th>
<th>Leverage</th>
<th>Market Cap</th>
<th>NPM*</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG Scores</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Div Payment</td>
<td>-0.158</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm Value</td>
<td>0.319</td>
<td>-0.054</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth</td>
<td>-0.166</td>
<td>0.352</td>
<td>0.139</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leverage</td>
<td>-0.311</td>
<td>-0.555</td>
<td>-0.312</td>
<td>-0.201</td>
<td>1.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Cap</td>
<td>-0.342</td>
<td>0.532</td>
<td>0.359</td>
<td>0.180</td>
<td>-0.292</td>
<td>1.000</td>
<td></td>
</tr>
<tr>
<td>NPM*</td>
<td>-0.478</td>
<td>0.566</td>
<td>0.158</td>
<td>0.1411</td>
<td>-0.320</td>
<td>0.926</td>
<td>1.000</td>
</tr>
</tbody>
</table>

*NPM = Net Profit Margin

As per the Table 6.3, the market capitalization is highly correlated with net profit margin ($r=0.93$). However, based on the review of literature, it was found that the net profit margin is one of the important determinants of market price. Hence, it was considered as a part of the analysis. Interestingly, leverage is negatively correlated with dividend payment ($r=-0.56$) and growth variable ($r=-0.20$).
The results from the estimation of the above econometric equation are presented in Table 6.4 i.e. it indicates the results of Panel data regression analysis. It has been hypothesized that CG Disclosure score has a positive impact on the market capitalization of select companies.

**Table 6.4: Results of Panel Data Regression Analysis**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Market Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables</td>
<td>Coefficient</td>
</tr>
<tr>
<td>CG Scores</td>
<td>428.23</td>
</tr>
<tr>
<td>Div Payment</td>
<td>37835.89</td>
</tr>
<tr>
<td>Firm Value</td>
<td>5697.51</td>
</tr>
<tr>
<td>Growth</td>
<td>310.00</td>
</tr>
<tr>
<td>Leverage</td>
<td>24160.73</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>17.26</td>
</tr>
</tbody>
</table>

According to Table 6.4, the coefficient of CG scores is positive at the ‘t’ statistics value of 0.87 with 95 percent confidence level, but it is not statistically significant. Hence, the hypothesis has been proved and
found that CG Disclosure score has a positive impact on the market capitalization of select public sector companies. However, the positive sign is statistically insignificant.

In this study, the empirical results found that the market performance is influenced by Corporate Governance Disclosure practices of the company. Thus, it can be concluded that better Disclosure practices as per the Clause 49 of the Listing Agreement will result into better performance. According to the general theory of finance, leverage should increase the shareholder’s returns and the sign of leverage is expected to positive. However, the dividend payout, leverage and growth in sales indicate positive sign but statistically not significant. Whereas, the Firm Value and net profit margin were found to be positive and statistically significant. The results of the present study are very useful to investors. The Corporate Governance Disclosures facilitate the investors in making more informed decisions. The results are also useful to management of the companies, regulators and policy makers.
6.7 SUMMARY & CONCLUSIONS:

In this chapter, an attempt is made to capture the significant relationship between CG scores and the market performance of select public sector companies in India. It has been hypothesized that CG scores has a positive impact on the performance of companies. The sample is drawn from Bombay Stock Exchange (BSE). In India, it is mandatory to all the listed companies to present their Annual Reports as per the Disclosure norms given by SEBI’s Corporate Governance provisions under Clause 49 of the Listing Agreements. The study was covered for a period of five years that was from 2004-05 to 2008-09. Based on the pooled cross section time series analysis, it is proved that CG score has positive impact on Market Capitalization of select public sector companies in India. The hypothesis is proved but statistically insignificant. It is evident from the results and analysis that better Corporate Governance Disclosures result into better performance of the companies. The present study supports the results of (Meek et.al., 1995), (Ettredge et al., 2002), (Haniffa and Cooke, 2002) that Corporate Governance Disclosure practices have positive influence on the firm performance. The results of the present study are useful to investors, management, regulators and policy makers. Further, similar kind of studies can be carried out with a larger data set and across the various types of companies.
6.8 REFERENCES:


Note: Refer to bibliography for the full list of references