CHAPTER - 2

REVIEW OF RESEARCH AND METHODOLOGY

This chapter highlights conceptual clarity, multidimensionality of corporate governance analysed in the previous research studies and explain the issues taken up and the methodology adopted for the present study.

2a. RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE

Worldwide, there have been significant developments in recent years in the area of corporate governance, very often extending the scope of responsibility of those entrusted with the task of running businesses with other people's monies. India cannot afford to lag behind, given its commitment to move towards a market driven economy and globalization of its trade and services.

1. Higher awareness: Thanks to improved communication, the world has shrunk to a small village. People are aware of what is happening elsewhere in every field of activity. Defrauded investors in the country now wonder why they should not have the same/similar rights of redress that people in other parts of the world seem to enjoy. Some recent regulatory interventions with regard to non-banking financial companies should be seen in this light.

2. Greater expectations: Thanks to improved financial journalism, and development of capital market, investors are more conscious of the risk-reward equation.

3. It is probably a matter of time that before equity investments in Indian companies (public and private) becomes a way of life, the system should ensure closer monitoring of corporate performance. “As many as 2500 of the 3900 companies that got listed between 1991 and 1996 have completely disappeared. It is almost not possible to discover what happened to these corporations, as there are no annual reports or any other form of published information about them” says – Narayana Murthy.

4. Higher pay- higher performance: With the increase in managerial remuneration, good performance should increase proportionately. After all, one expects value for money in goods and services, why not in management.
5. **Recognition of contestability**: Contestability is coming to the fore, potentially leading to a spate of mergers and acquisitions. As per KR Rajesh: “If incumbent teams fail to deliver, investors are quite willing to look for other teams and with that gone soon will be the days of inherited managerial opulence. Each succeeding generation of entrepreneurs will have to earn their goodwill; many families owned companies are aware of these possibilities. They started handing over managerial control to professionals while retaining ownership control. Inherent in such developments and the consequent need for closer monitoring will be good and transparent practices that are essential building blocks of corporate governance.

6. **Financial institutions**: Such institutions had in general followed a relatively relaxed and hands-off approach to the companies they had invested. Many of them now are more conscious of their accountability to their stakeholders. Competition is also spurring them to make their investments more productive than ever before. Institutional nominee directors are increasingly being asked to take a broader and more comprehensive view of their companies rather than just protecting their institutional stakes. This will call for more detailed and timely information from companies, again a basic ingredient for good corporate governance.

7. **Company boards**: From old-boy clubs, company boards are emerging more and more as trustees of shareholders. It will no more be a pleasure to be invited to join the boards of listed companies. Future appointments will carry a heavy price tag of responsibilities, neither meticulously detailed nor enforced earlier. There will be commensurate and transparent remuneration for the labour of being a director. Clearly, for many, it will soon be good-bye to multiple directorship and board hopping with the extension of better governance.

8. **The corporate world in India** is now ready to formally recognize the need for better standards of governance and improved transparency. This, in itself, is a major break through. What is needed now is to build upon this foundation and move towards more advanced levels of corporate governance in the years ahead.
2b. AREAS OF ATTENTION

The establishment of World Trade Organisation is opening up new international frontiers for global trading which would not only provide for the participation of the investors from within the country but also from outside the country. Therefore enabling provisions of the corporate laws would be such that every national law has a certain minimum corporate discipline acceptable to investors from all the countries.

Globalisation is not a one-way process, hence, Indian corporates have to operate increasingly in other countries to raise resources, or establish joint ventures etc. It would imply that our corporates, especially larger ones, should meet global standards in corporate governance.

The role of foreign institutional investors (FII) in corporate governance cannot be ignored. Particularly, after the Asian crisis, the Indian companies have been placing a lot of emphasis on how to attract foreign investment. From the macro economic point of view when India wants capital inflows, it should adopt better standards of corporate governance.

The creditability of professional organizations like the Audit firms should be of high order, both with respect to the adequacy and integrity of disclosures. The irregularities raised questions about the possibility of inadequacies. Professional bodies should assure quality that would satisfy international standards. With regard to company secretaries also, the question of quality arises. In the context of corporate governance, company secretaries could carve out a special and unique role for themselves.

Hence, a careful study of systems of corporate governance is important and Countries will need to take a long hard look at the way other systems work and keep their own under review; to tolerate a poor system is to impose upon oneself an unnecessary competitive handicap.

The corporate governance in future would have to take into consideration the following dimensions of corporate governance.

- Understanding the reality of process by which future companies will be governed.
Reliance on ethics and values likely to prevail in future

Social responsibilities of companies.

New models of shareholders' democracy

2c. STUDIES ABROAD

It is worth noting that in US research studies are conducted on regular basis and the American Law Institute (ALI) Publishes on regular basis fair and unbiased statement of the Law for use by courts and practitioners on the subject of corporate governance. The existing literature addresses three issues:

- Effectiveness of the board.
- Optimality of existing board structures, and
- Interplay between internal and external corporate governance mechanisms

The literature focuses on the monitoring role of the board, the composition of the board and how it affects firm performance, and its optimal size, committee structure, and compensation structure. Studies find that the board plays an important monitoring role. The results on the effect of the composition of the board on firm's performance are mixed. We would expect independent boards dominated by outside directors to make value – maximising decisions, without regard for management's preferences as compared to boards influenced by management. Several authors find a positive relationship between firm performance measured by stock returns and by the level of independence of the board. However it could not be concluded that there is a relationship between board composition and firm's performance.

An examination of literature and research studies undertaken by researchers on corporate governance in US reveals the following aspects. A study on Reality of American Corporate Boards (1991-1995) by Jay. W. Loesh Paunsor reveals that the norms of behaviour in most boardrooms are dysfunctional which results in inhibiting independent directors to participate actively. In 80% of the companies in USA, Chief Executive officers have been found to be the chairmen and this quite often makes it difficult for independent directors to carry out monitoring role.
A survey conducted by Koin and Ferry\(^4\) in 1992 revealed that 98% of the responding companies had an audit committee, 95% had a compensation committee, and 67% had nominating committee.

Michael J. Peel and Edmond O'Donnell\(^5\) (1995) examined Board Structure, Corporate Performance and Auditor Independence. This paper provided detailed evidence relating to board structure, corporate performance and auditor independence in respect of a sample of 132 UK listed companies. Evidence was presented in respect of board composition and director turnover rates, together with the impact of CEO duality and other governance variables on corporate performance. In addition, the important issue of auditor's independence and consultancy fees was also examined.

In general, there appeared to be a reasonably high compliance rate with the Cadbury recommendations with regard to the chairman and chief executive appointments, and also with regard to outside director’s board representation. In addition, the vast majority of companies were complying with the advice in the Cadbury Report in respect of outside directors not participating in share options schemes.

Finally, the level of joint audit and consultancy fee was very high (92%). The analysis demonstrated that consultancy fees provided substantial additional income to audit firms, and therefore the potential for the impairment of audit independence, via joint audit/consultancy appointments, is substantial.

Fizel and Louie\(^6\), noted the basic premise of the theory that executives and owners have divergent motivations, and if there is no mechanism by which executives are dissuaded from acting in their self-interests, they will be free to maximise returns to themselves rather than fulfill the profit-maximising objective of owners.

Board members are typically classified as either non-executive outsiders or executive insiders. As an employee of the firm, an executive director usually holds a high level executive position and devotes substantial time to the affairs of the corporation.
"Kenser & Johnson7 1990 found in an Investigation of the relationship between board composition and stockholders suits & Strategic management that executive directors because of their direct involvement in day-to-day organizational activities bring specialized knowledge and experience with them to the board. In addition they also serve a direct communication link between Board and remaining organizational members and therefore help implementing corporate goals and strategies. Board membership for executive directors may also serve an educational and developmental role for younger managers and be used as an incentive or reward for managerial performance.

Patton and Baker8 1987 in "Why wont directors rock the boat"—comment "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 contacts, which enables them to enhance managements ability to secure scarce resources and to align the external environment. They represent change agents and bring new perspectives.

Goodstein J. Gautam, & Boeker, W.9(1994) in "The effects of board size and diversity on strategic change." quotes that the diversity of board composition should not only be measured by the ratio of outsiders to insiders. A useful differentiation can be made between demographic and cognitive diversity among the board members. Demographic diversity relates to differences such as age, sex, race, and nationality. Cognitive diversity refers to an individual's knowledge and skills, needs and motives, beliefs and values.

Of the 42 delegates who attended the Stanford Directors Conference, the five important tasks of board of directors were listed as follows10:

<table>
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<tr>
<th>Task</th>
<th>No. of delegates selecting the task as important</th>
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<tr>
<td>Monitor and evaluate long-term strategy</td>
<td>--- 34</td>
</tr>
<tr>
<td>Evaluate senior management performance</td>
<td>--- 28</td>
</tr>
<tr>
<td>Monitor and evaluate current corporate performance</td>
<td>--- 25</td>
</tr>
<tr>
<td>Manage CEO succession</td>
<td>--- 15</td>
</tr>
<tr>
<td>Maintain legal and ethical practice</td>
<td>--- 13</td>
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The article "The governance structure and performance of large European corporation" by Henk Wouter De Jong first describes the governance structure of groups of large European corporations, viz, the Anglo-Saxon, the Germanic and the Latinic types of firms. It is found that Continental corporations have a performance which is equal to or better than that of the Anglo-Saxon group. Combining the structural and performance outcomes, the explanation seems to be that the dominance of capital markets and the market for corporate control force Anglo-Saxon managements to maximise returns on capital, whereas Continental firms have a wider range of options. The performance criteria chosen are growth, productivity, employment and shareholders returns. The data are derived from a refined analysis of the annual accounts of those firms over the period 1991 – 1994.

Kose John & Lemma Senbet (1998) in "Corporate Governance and Board Effectiveness" expand the definition of agency conflicts to include those occurring among stakeholders of the firm, viewing the firm as a nexus of contracts among outside claimants, including equity holders, debt holders, employees, and society at large. The purpose of corporate governance is to reduce the costs of agency problems within a firm in order to attain wealth maximization.

Studies document inverse relationship between market valuation of a firm and the number of members on its board, implying that it would be beneficial for firms to limit the number of directors. Klein (New York University Working Paper, 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.

Eisenberg, Sundgren, and Wells (1998) suggest two reasons why small boards lead to greater profitability. Using a sample of small firms between 1992 and 1994, the authors examined the relation between board size and firm profitability. They find that firms with smaller boards have greater industry – adjusted profitability.

First, as the size of board of director’s increases, problems of communication and coordination may increase. Second, as a board’s size increases, the board may lose the ability to effectively monitor managerial actions. Without effective monitoring of managerial actions, divergent incentives lead to costly conflicts between managers and shareholders. For example, managers might over invest in plush offices or undertake value – decreasing, yet compensation – increasing investments.
John A. Wagner, J. L. Stimpert I. Fubura (1998) presents 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 – indicates 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 suggest the existence of curvilinear homogeneity effect in which performance is enhanced by the greater relative presence of either inside or outside directors. The second study – a hierarchical polynomial regression analysis of data from 259 large US companies – confirms the existence of curvilinear relationship between insider/outside composition and performance measured as return on assets.

Insider/outsider research is based on the premise that boards of directors in general, and the compositional characteristics of boards in particular, should influence organizational performance. 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 discernable effects on the firm’s performance.

Consistent with this viewpoint, major investors have targeted insider/outsider board composition as a key concern, advocating that boards of directors should be controlled by outside directors beholden to the interest of equity owners and not by insiders who might compromise those interests to the concerns of managers in the firm.

In the study “Corporate governance and firm diversification” by Ronald C. Anderson, Thomas W. Bates, John M. Bizaal & Michael L. Lemmon (2000), empirically investigated whether corporate governance structure is different between focused and diversified firms, and whether any differences in corporate governance are associated with the value loss from diversification. They found that firm’s - CEOs in diversified firms have lower stock ownership and lower pay – for – performance sensitivities. Diversified companies, however, have more outside directors, no difference in independent block holdings, and sensitivity of CEO turnover to performance similar to that in single segment firms. Moreover, there was no evidence that internal governance failures are associated with the decisions to diversify, or that
governance characteristic explains the value loss from diversification. Their findings suggest that diversified firms use alternative governance mechanisms as substitutes for low pay – for performance sensitivities and CEO ownership. They conclude that agency costs do not provide a complete explanation for the magnitude and persistence of the diversification discount.

In the paper "The Governance of Directors' Pay: evidence from UK Companies" by Andrew Benito & Martin J. Conyon17 (1999) examined the determination of directors' compensation in UK quoted companies between 1985 and 1994. The primary innovation contained in the paper is the focus on the governance mechanisms that determine pay outcomes. Their results indicate that:

1. Directors' compensation is positively related to pre-dated shareholders returns and company size with the quantitative effects of the latter dominating the former.

2. They found that the pay-for-performance link has become quantitatively stronger over their sample period.

3. There has been positive adherence to the principles of the Cadbury report, but these variables play little statistical role in shaping the direct compensation of top directors.

The determination of executive compensation has emerged as an issue of considerable academic and media interest. A central theme in the UK debate is whether directors' pay is adequately tied to measures of corporate performance. Much of evidence assembled so far indicates that if a link between pay and performance can be established then its magnitude is quantitatively quite small relative to the effect of company size. They examined the link between directors' pay and the stock-market performance of their companies. They also observed whether there is any time series variation in the directors' pay and company performance relationship. They examined the effects, if any, of boardroom governance variables on directors' pay.

The paper "Financial Reporting, Private Disclosure and the Corporate Governance Role of Financial Institutions" by John Holland18 (1999) explores how large UK financial institutions (FIs) pursued a private corporate governance agenda with their portfolio companies. It also investigates the role of financial reporting in
private and public corporate governance. The core financial institutions argued that the limited quality of public information, especially in financial reports, was a major constraint on their ability to act in fund management and corporate governance roles. However, the financial reporting cycle determined a private institutional and company meeting cycle and this created opportunities for private information collection and for governance influence by FIs. In addition, the perceived limitations of public governance mechanisms such as voting encouraged private governance approaches. As a result, the core financial institutions had the incentive and the means to improve the quality of their sources of corporate information and to obtain a competitive edge over other financial institutions and the market through their direct contact with companies. Despite the limitations of public information, the paper reveals how public disclosure in financial statements and financial reporting cycle played a central role in corporate governance. Public sources of information were combined with private sources to create a financial institutional knowledge advantage. The institutions used this knowledge to diagnose problem areas in strategy, management quality, and the effectiveness of the board, and their impact on financial performance. The financial reporting cycle meant that the quasi insider financial institutions had the access opportunity and the joint public/private insight to influence companies across a wide corporate governance agenda. The institutions exploited these private access and knowledge advantages for investment purposes. Thus, the private governance process was critically dependent on the knowledge advantage, which in turn relied on both financial reports and private disclosure. This wide-ranging governance behaviour by institutions corresponds to recommendations subsequently made by the Hampel report in 1998 concerning UK corporate governance. The paper ends by exploring how the private institutional and company meeting agenda can suggest new directions for financial reporting and public disclosure and how this can further improve public and private corporate governance.

To the degree that directors contribute to strategy, research has viewed their role primarily as dealing with the conflict resulting from divergent preferences of agents and principles. In the paper "What Corporate Boards Have to do With Strategy: A Cognitive Perspective" by Violina P. Rindova15 (1999) said that "Traditional research on corporate governance has viewed the contribution of corporate directors to strategy making as limited by their lack of independence or firm-specific knowledge. The cognitive perspective suggests that directors contribute to dealing with the complexity and uncertainty associated with strategic decisions. It argued that directors possess valuable problem-solving expertise, which they can
apply to a variety of contexts. Directors make their cognitive contributions to strategic decision making by performing along with a firm's managers a set of cognitive tasks scanning, interpretation and choice.

In an interview with the CEOs and directors the author found that 'The changing of the board's role is seen as a process of evolution in which the board moves beyond providing basic legitimacy for the corporation to more actively auditing the results of corporate performance and, finally, to playing an involved role in questioning the viability of the firm's long-term directions and success.

The issue of control has dominated academic discussions on boards of directors ever since the numerous small stockholders lose their power over the management of a company.

Agency theorists identify boards as internal monitoring devices that monitor the degree to which managers act consistently with shareholders' interests. A central function of corporate boards is to oversee managers and to replace them when necessary. In performing this function boards are a lower cost mechanism for replacement of managers than the market for corporate control.

Statistics about board composition indicate that board members possess substantial strategic problem-solving expertise: 94 percent of the firms Hedrick & Struggles surveyed in 1990 had directors who were CEOs or COOs of another company, 80 percent recruited from retired executives, 62 percent sought academic talent, and 50 percent looked for senior managers who are not CEOs or COOs of other companies.

The paper "Board Composition, Managerial Ownership, and Performance: An Empirical Analysis" by Scott W. Barnhart & Stuart Rosenstein (1998) examined sensitivity of simultaneous equations techniques in corporate governance research. They adapted Tobin's q model board composition, and managerial ownership using a three-equation instrumental variables approach, with two specifications and four instruments, found that the variables are jointly determined.

The paper investigated the combined effects of ownership structure and board composition on corporate performance, using an instrumental variables approach. The approach is more general than three-stages least squares, and more importantly, it allowed the final results to be subjected to sensitivity analysis.
The evidence indicated that inside ownership, board composition, and firm performance are jointly determined. However, the author explained the limitation that the estimates from each equation in the three-equation system are quite sensitive to reasonable changes in both the overall model specification and the first-stage regressions. Co-efficient estimates and test-statistics vary widely with changes in the first-stage regressions, even for identical model specification.

Shareholders activism has become one more important aspect of the US corporate governance system. The article by Diane Del Guercio and Jennifer Hawkins\(^2\) relates the institutional activism to the investment objectives of the funds and concludes that differences in institutional activism are explained by differences in fund objectives.

This article provided an overview of shareholders activism by institutional and individual investors. In addition a brief history of their activities, background on the identity of shareholder activists and the corporate governance reforms they seek were stated. They also presented a survey of the theoretical and empirical research regarding the motivations and outcomes of shareholders activisms.

An article by Kose John and Lemma Senbet\(^2\) (1998) examined the effectiveness of corporate governance in addressing agency problems. The authors specifically look at evidence regarding the effectiveness of the board in monitoring management's behaviour and the importance of the composition of the board of directors.

Rao\(^2\) (1994) has pointed out that it is not the separation of ownership that is sole cause of the agency problems; rather it is the atomization of ownership. Because ownership is so diffuse, that is, a large number of small shareholders there is no incentive for any individual owners to take on the task of monitoring the managers. Other authors have suggested that a large shareholder may take on the task of correcting agency problems by monitoring or otherwise taking control of the corporation.

They concluded that, shareholder activism has been present in US markets for most of this century. Between 1943 and mid – 1980s, the shareholder proposal process was almost exclusively the domain of individual shareholders or religious or political groups. However, with the initiation of public pension fund activism in 1985, the involvement of large institutional shareholders has increased.
A number of theoretical studies provide the rationale for shareholders, particularly large shareholders such as institutional investors, to become active in monitoring of corporations. The major motivation is that any shareholder has the potential to enhance the value of their investment by undertaking costly monitoring activities. However, because all shareholders participate in the gain from monitoring, only the large shareholders will obtain a return on their investment that offsets the associated monitoring costs.

The empirical evidence as to the influence of shareholders activism is mixed. While papers have found some short – term market reaction to the announcement of certain types of activism, there is little evidence of improvement in long – term stock market performance or operating performance after the activism. Studies have found some change in the real activities of the firm subsequent to the shareholder pressure, but it is difficult to establish a casual relationship between shareholders activism and these changes.

In their paper Patrick Bolton And Ernst-Ludwig Von Thadden (1998) developed a theoretical model that illustrates the costs and benefits associated with varying degrees of corporate ownership concentration. Specifically, they demonstrated that the trade-off between liquidity and control is determined by ownership concentration. Greater levels of ownership concentration serve to both improve the incentives for managerial control and conversely reduce trading opportunities for investors. Alternatively, ownership structure that is widely dispersed will result in increased trading opportunities, but may lead to a value-reducing due to lack of control. Two important simplifying assumptions of the model are that the number of shareholders trading the stock may significantly influence secondary market trading and that wealth constraints can be ignored.

When analyzing the trade-off between liquidity and corporate control, the authors demonstrated through their model that this trade-off is dependent on only three variables.

- The first variable is the investor’s average demand for liquidity. It is shown that when the demand for liquidity is large, the value of liquidity becomes greater and higher levels of dispersion are expected. Conversely, when the demand for liquidity is small, the resulting value of liquidity is lower and greater concentration of shares is expected.
The second key variable is the cost of gaining a controlling stake in the firm. Here the model reveals that when shareholders are faced with high potential costs of future interventions, ownership concentration becomes more valuable.

The third variable is the total number of shares traded. When there are few shares available for trade, optimal ownership structure depends on the other variables. However, as the number of traded shares trends towards infinity, ownership dispersion is preferred.

This model also implies distinctly different forms of ownership and capital structure dependent on firm size and, more broadly, on the regulatory and environmental characteristics of a country. Generally, the authors’ analysis demonstrated that both dispersed and concentrated ownership structures may be optimal depending on the characteristics of the firm and on the regulatory environment in which it operates. There are several implications regarding the relationship between ownership structure and firm size.

For small firms, the problem is how to obtain financing while minimizing the loss of control. Managers typically choose either debt or venture capital. If the firm performs adequately, suppliers of capital receive their desired return and managers maintain control. However, when the firm performs poorly, managers lose control to financiers. The authors point out that observation across countries show that this scenario holds with little variations.

For large firms, managers are less interested in maintaining control since benefits of control are often already maximized. This is because large firms tend to have more dispersed ownership, and, therefore, individual investors have less influence. However, ownership structure of large firms will vary across countries depending on the rules and regulations in place and the resulting system of corporate governance employed. For corporate governance systems that operate in economies with active secondary and takeover markets, the analysis shows that more dispersed ownership structure will emerge. In addition, it is demonstrated that the resulting liquidity in the secondary market facilitates takeovers by reducing free riding. This corporate governance system is observed in countries such as the United States, United Kingdom, and Canada. Conversely, for corporate governance systems that operate in economies with less developed secondary markets and inactive takeover markets, a concentrated ownership structure emerges. This system is observed in
Japan, Germany, France, and South Korea. The authors also pointed out that implications regarding the tradeoff between liquidity and control derived from their model can also be applied to debt financing. Therefore, as found with many corporate governance systems, banks perform monitoring functions and influence managerial decisions.

The empirical evidence on the impact of CEO duality on corporate performance is mixed. For example, US studies have found that CEO duality is associated significantly with both superior corporate performance and with inferior corporate performance.

There are numerous reasons why one might expect that founder CEOs will often possess skills and face incentives that translate into firm performance superior to that commonly attained by non-founder CEOs. For example, founders are likely to be superior CEOs because they highly value their reputational stake in the firm and, hence, exert a greater effort than non-founder CEOs to ensure firm success. Founders also tend to own a significant fraction of their firm’s equity. Significant equity ownership on the part of corporate managers can serve as an effective mechanism for reducing principal-agent conflicts of interest. Specially, since their personal fortunes are often tied to those of their firms, founder CEOs may be especially likely to work diligently and invest in developing their managerial skills. The effect of this situation could be superior firm performance.

Moreover, a ready willingness to undertake risk and high need for achievement are characteristics that one might expect to generate and sustain superior performance over time. Tentative evidence suggests that these characteristics may be higher among founder than non-founder CEO’s.

On the other hand, it is possible to conceive of scenarios under which founder management could be detrimental to the performance of firms. For example, to the extent that a founder’s interests diverge from those of the firm’s other shareholders and manifest themselves in the form of excessive perquisite consumption, poor performance may result. Similarly, in their desire to refrain control over corporate affairs and resources, founder CEOs may be particularly likely to refrain from adopting liberal cash payout or dividend policies – an action that could reduce the firm’s market value.
Founders create their organisations, yet are often expected to eventually become liabilities to these same organisations. Narayanan Jayaraman, Ajay Khorana, Edward Nellling and Jeffrey Coven26 (2000) studied 94 founders and non-founders managed firms and finds that founder management has no main effect on stock returns over a 3-year holding period, but that firm size and firm age moderate the CEO founder Status-firm performance relationship. In particular, this study examined and found the following research observations:

1. Firms with founder CEOs perform differently, in general, than those without such CEOs.


In Audit Committee Composition, “Gray Directors”, and interaction with internal auditing (2001),“K. Raghunandan, William J. Read, and Dasaratha V. Rama27 examined the association between audit committee composition and the committee’s interaction with internal auditing. Their results, based on responses from Chief internal auditors of 114 public companies, indicate that committees comprised solely of independent directors and with at least one member having an accounting or finance background are more likely to (1) have longer meeting with the chief internal auditor; (2) provide private access to the chief internal auditor; and (3) review internal audit proposals and results of internal auditing. These findings provide empirical support for the BRC’s recommendations related to audit committee composition. The functioning of corporate audit committees was criticized in the recent years.

They examined the five research questions with five multivariate regression analyses to control for other factors that may be associated with the activities of the audit committee, including interaction with internal auditing.

2d. STUDIES IN INDIA

Turning to the academic research in India on corporate governance, it should be noted that at the present stage it hardly scratches the surface, even while defining and examining the legal aspects, the debates tend to be normative (prescriptive)
based on the experience of the western countries. There is a lack of coherent perspective remedial measures, which can protect the minority shareholders and eventually induce them to provide more equity financing.

Conceptualizing what is possible, even if it is an academic exercise to begin with, has been discouraged. Rao & Saha\(^{26}\) (1994) examined the nature of the effect of ownership on corporate performance. First, it was observed that for any given distribution of shareholding the exercise of control is necessitated by the frequent changes in the environment and constant exchanges in the deployment of productive assets. The only form of ownership, which has some positive effect on corporate performance, is the shareholding of the directors and their relatives.

Rastogi & Rao\(^{29}\) (1995) also investigated the reasons for the shareholders and/or the board of directors keeping corporate control if ownership is not the decisive determinant. They noted that the board might experience:

- Inadequate information with respect to the market conditions external to the firms or distinctive capabilities of the organization.
- Constraints in devising organizational structures to implement their strategies.
- If these risks are sufficiently low, the board keeps control.

When the risks increase the optimal arrangement is to delegate the decisions to the management. However, there is a necessity to ensure that:

- Decisions made are commensurate with the organizational capabilities to execute them.
- Efficiency is maintained at the operational level, i.e. make the management work for the shareholder’s objectives.

The question of the fiduciary responsibilities of the board of directors, their performance, and the ability to bring the errant director to law then become significant issues. Under the existing legal framework the board of directors is expected to counterbalance the management and make sure that the company and the minority shareholders are not subjected to losses. In general, the non-executive directors have a fiduciary role in their specialized areas of expertise and can act only on the basis of information provided by the management (Abraham & Bhide, 1996)\(^{30}\)
Some observers (Maitra 1997) suggest that the number of the non-executive directors should be at least two thirds of the board to ensure that the promoters and the managers can be kept in check. It appears, however, that the more significant problems are that the same directors serve on too many boards. As a result, they pay inadequate attention to their duties.

The laws regarding the empowerment of the board and their responsibilities are also extensive. The board has the power to approve decisions with respect to:

- Diversification of business.
- Mergers and reconstruction.
- Takeover of companies.
- Buy back of shares.

In general, the mechanisms of corporate governance have been defined elaborately to ensure value maximization. However, the task before the enforcement agencies is gigantic, their expertise did not keep pace with requirements and the law enforcement is slow and effective. Corporate mismanagement is perpetuated as a result. T.V.S. Rammohan Rao (1998) explains the Indian scene which reflects the following trend.

- The experiences with the managing agency system and the embedded corrupt practices are continuing. The role of the business houses and promoters of corporate entities leaves a lot to be desired.

- The average shareholders do not have much expertise and they are being exposed to the risks of dealing with the corporates in a big way only recently. Hopefully they will be wiser very soon. In one sense the development of mutual funds and a host of debt instruments is unhealthy because the prospect of fostering democratic discipline in equity markets is getting delayed.

- The pace of change over the past decade is disproportionate to the capabilities of the managers, experts who serve on the boards, and the law enforcements agencies.
The academic community has to systematically examine the ground realities, consequences of different governance mechanisms and articulate suitable alternatives.

Several research studies have been conducted to know the effectiveness of the board system in India. A research study titled "Board Room Practices in India" conducted by Dr. C. L. Bansal in 1989 is worth mentioning. He examined the structure, composition and functioning pattern of corporate boards of 100 corporate leaders and the process of historical evolution of Board management system in India. The major findings of the study were the shift from the family board to the professional boards and also most of its findings are similar to that of Cadbury Report of 1992.

The main findings of his study are:

1. The evolution of Board of directors as top most governing organ was sudden, super imposed and through a legal (fiat) system.

2. Corporate leaders adopted practices relating to composition and structure of the Board conforming to the corporate practices prevailing in advanced countries.

3. The study revealed a diversified shareholding pattern varying from a minimum of 100 shares and a maximum of 10 lakhs shares. A generalisation however is difficult to the existence of substantially large share holdings by the institutional investors.

4. The relative importance of a director does not depend on the number of directorships he holds; rather it depends on the gross value of assets of each such company and the number of directors on its boards.

5. The experience possessed by the directors directly contributes to the effectiveness of the board. An analysis of experience pattern of the boards of corporate leaders reveals that the time span of total experience of a large majority of directors falls in the range of 16 to 40 years. A substantially large number of directors have spent almost their entire lifetime in the same company.
6. In general, the representation of the traditional business houses on the board in their respective companies had found to be quite high.

7. On the whole, the boards have been found to be non-executive in their composition. Dr. Bansal found a shift from family Boards to professional boards.

Yet, Gupta's (1997) survey of the early 1980's found that the nominee directors presence had brought about some formality and openness to board practices. He says:

"Before 1971, many companies did not observe even the elementary conventions such as sending notices of meetings and agenda to the board members in advance, bringing all important matters before the board, furnishing the annual operating budgets and periodic reports on performance to the directors, allowing proper discussions at board meetings, etc. It was not uncommon experience even in well-established companies board meetings were brief – lasting less than 20 minutes. Boards were neither involved in supervision of management nor in decision-making, but simply in fulfilling a legal responsibility. This is changing under the influence of public financial institutions and their nominee directors, for although there is still a long way to go to secure board effectiveness in the real sense, the outer discipline in board functioning, i.e. observance of proper procedures, has distinctly improved".

Business today (Jan 7, 1998 – Feb 6, 1998) published a survey of Indian family business houses. Some of the important points stated there are:

1. A few Indian houses are showing the highest standards in their dealings. On the other hand, company management with poor integrity is not changing despite all the talk. For them discussing corporate governance is just actively participating in discussions and interviews.

2. Mutual trust amongst the senior managers is very low.

3. Family owned companies are the least preferred employers.

4. Career development is uncertain in family owned companies.

5. The level of transparency in business houses is below average.
6. The level of stability is very high in family business.

7. A very high percentage of respondents think that family business houses are less ethical.

Despite high level of stability, family owned business houses are not very highly preferred by employees.

Mr. N. R. Narayana Murthy(1999)\textsuperscript{36}, chairman and Chief Executive Officers of Infosys Technologies observes, "Corporate Governance is not to be measured merely in terms of stock market valuations. For me corporate governance is a mindset, a question of value systems. It is a way of saying that I put public good ahead of private good, of not using the corporation's resources for personal benefit".

Mr. S. H. Khan\textsuperscript{37}, former chairman of IDBI quoted a study on corporate governance of 30 companies which found that companies with low promoter shareholding and chairman from outside the promoter group were having more effective corporate governance practices and the presence of outside directors was said to have helped corporate performance. (The Economic Times, Mumbai 1998)

Mr. Rao & Saha\textsuperscript{38} 1994 examined the nature of the effect of ownership on corporate performance. First it was observed that for any given distribution of shareholding the exercise of control is necessitated by the frequent changes in the environment and constant exchanges in the deployment of productive assets. The only form of ownership, which has some positive effect on corporate performance, is the shareholding of the directors and their relatives.

Sir Adrian Cadbury\textsuperscript{39} in a seminar advised Indian business leaders not to import systems of corporate governance but to adopt international recognized principles to suit the country's requirements because governance systems are not exportable.

Speaking at the same seminar, Mr. Rahul Bajaj\textsuperscript{40}—chairman of task force CII pinpointed the root social malaise that has to be overcome: "Many family owned companies have several executive directors. Does it mean they are best managed? Of course it is unholy club. "Speaking at a seminar at Mumbai in November 1996. He said, "All of us know what we should not do. We have done things that are legal – but questionable. Why should we need a committee to tell us what to do?"
T.N. Pandey\textsuperscript{41} quotes the findings of the first Indian corporate governance survey conducted by Egon Zehnder International in December 1996. The point highlighted by them is that the posts of Chairman and Managing Director are not separate. Their key findings regarding board's effectiveness are:

- Provide outside / past experience / wisdom --- 89%
- Checks and balance by executive directors --- 79%
- Offers independent / objective view --- 38%
- Check / advice / on strategic planning --- 34%
- Represent interest of shareholders --- 19%

The corporate governance survey of Egon Zehender International brought forth the following response about the influence of non-executive directors:

- Too much influence in board decisions - 1.5%
- Too little influence - 82.25%
- About the right amount of influence - 11.29%
- Don't know - 4.83%

According to Mr. N. Vaghul\textsuperscript{42}, non-executive chairman of ICICI --- “Non-executive directors should ideally provide a constructive and critical supervision of executive managements. They should not only react to issues placed before the board, but take an enlightened interest in static business issues”.

A survey carried out by Business Today on corporate governance ranks HLL at top followed by Bajaj Auto, a family managed company with little presence of outside directors as number four. This signifies that even a closely and unfairly held company can adhere to best corporate practices, if there is a will.

The concept of employee directors can ideally be workable through free exchange of opinion and pooling of wits for decision-making in the best interest of the company. This encompasses the basic management philosophy of empowering the executives and making them feel part of the company like Japanese do.
Rajesh KR. Jain (1999) in his project submitted to IIM (Calcutta) states “In most family business houses, systems are not formal. The owner managers lack accountability. In the name of outside directors, corporate boards include close friends and relatives. Board meetings are get-togethers. Most of the issues are decided in advance and the board acts as a rubber stamp. All this makes the life of the professional manager miserable. All the credits go to the owner managers and all the blames are put on the professionals on the plea that (a) being professionals it is their duty to deliver, and (b) if they knew a decision to be wrong, it was their duty to protest, after all professionals are not supposed to be yes men. After a while, the professionals either learn the art of being the yes men or they lose their ability to identify the area of problems and indulge into self accusation, when they are not wrong and defensiveness, even if they are wrong.

Business is controlled through control of finance and accounts. Presence of unethical practices also necessitates that, apart from the accounts department, probably nobody else knows the true story. There is lot of hush – hush and secretiveness in the air. Access to necessary data is denied. Decisions are based on misrepresented facts and figures. This results into tremendous pressure on professionals not in the confidence of the management. This also opens up avenues for excuses, but true professionals are not satisfied with offering excuses. They are more interested in the thrill of success achieved after fair play notwithstanding the chances of failure.

Corporate governance is an outcome of doing business sensibly. Corporate culture, commitment to sustained profitability, sense of responsibility and sincerity towards shareholders all go to make for good governance. Companies, which believe in good governance, are directly practicing it without making noise and without thinking too much about it. One of the biggest problems that we face in India is the inconsistency between promise and performance.

Successful companies world over derive their vision and motivation from their mission statements. The best examples of this commitment is the Johnson & Johnson case as Reported by A Rajesh Jain 1999 when they withdrew from the market medicines worth millions of dollars just because some poison coated capsules were found. No wonder, world over Johnson & Johnson’s mission statement is cited as an example.
After the above-mentioned crisis was over, General Robert Wood Johnson said, "you know why it worked; all that time we spend talking about the Johnson & Johnson credo, we really meant it". Recently Coco-Cola also withdrew a huge stock from the markets in Europe because some people felt sick after consuming its products as per the news item in Business today dated 7th June 1999.

In India, this commitment is lacking. The Economic Times, 14 July 1999, reports that in so far as corporate governance is concerned, companies have started using the phrase in their published accounts. But the accomplishment of the objectives of independence of the CEO, of the board and of the auditor is still a far cry. Of the thousand and thousands of the listed companies, so far, about five companies including Infosys, Hindalco, Punjab Auto and Nicholas Primal have come out with annual report based on the 16 CII recommendations (by 1999). The argument of self – regulation is on test. If all the constituencies who are affected by the quality of the governance of the company like the banks, the financial institutions, the investors, SEBI, stock exchanges and representative organisations like CII will start building up the pressure, growth oriented corporates will have to follow so on. Companies seeking global funds will not be able to do so if global standards of governance and transparency are not achieved.

Business Today, June 7 – 21 1999, in the article ‘Father, Sons & CEO’s ’ writes that the problem is that one generation of the owner – family may withdraw from the business, but ensuring that blood won’t trickle back into the veins of management. For instance, at Ford it is a fourth generation Ford, William Clay Ford Jr, who has taken over as Chairman from Alex Trotman although three of his predecessors were professional managers. As a matter of fact, shutting out the family altogether is not an idea that every expert approves of. However, “That would be unfair because it may restrict a competent family member, who’s also capable of running the business professionally from entering the company.” Asserts Ajay Piramal Chairman of Nicholas Piramal Group. He further says, “The members of my family will get an equal opportunity to prove their capability and rise to the top. The family that has created the business should remain in the business”.

Actually, the owners of these groups are bringing in an alternative model where the inheritor is trained to be a professional. Thus, all the successors of these groups are business school graded, honing up on their management skills at institutes like Stanford Business School (Mukesh Ambani) or Wharton Business
School (Anil Ambani, Mallika Srinivasan) They're also being trained as functional specialists, bringing to their jobs the same skills as professionals. This may lead to reconciliation, between the conflicting compulsions of professionalisation and family control.

The entire issue has to be looked at from the angle of value created. The business owners will have to ask themselves whether they are creating values or destroying values. How will the bottom line be affected by their being in it or being out of it. They should not take into consideration the opportunity cost of their involvement. Moreover, apart from the current profitability, the future growth and survival of the business should also be taken into considerations. It is always better for an ageing CEO to complete the process of succession within his lifetime.

Other important aspects are the size of the company/group and availability of the right professionals. When there is so much war going on for talent, it may not be easy to find the right person at an affordable price. For small and medium sized family businesses, their own involvement may be a better choice than hiring – a professional.

In so far as corporate governance is concerned India is going through a transition phase. Perfection is a pursuit only. Between the two extremes of success and failure, or true or false there is a vast area with varieties of shades of grey. One just has to make sure that the journey towards improvement goes on – in the right directions and in the right pace. The entire process has to be gone through – with some successes to build upon and some failures to learn from. As discussed in the beginning itself, corporate governance, after all is more of a reactive concept. Failures keep the check on complacency.

Moreover, since the concept is dynamic and evolving the journey towards improvement shall always be never – ending. In between, confusion on the part of genuine business owner and window dressing on the part of ingenuine promoters the situation look a bit phony or cosmetic. But generalization should not be adhered to. It is all part of the process.

An attempt is made by Dr. Jinesh N Panchali (1999) in "Promoting Corporate Governance: Role of Mutual Funds" to survey the corporate governance system in India and abroad and to suggest the role of a fund manager in guiding the corporate board's decisions. The law states what a company board should not do rather than what it should do. As such the precise definition for corporate governance
is not available. But the degree of accountability the corporate board shows towards its stockholders is the benchmark for evaluating the corporate governance says the author. To achieve this, the commitment and capability of outside directors/non-executive directors is vital. The composition of outside directors and inside directors is varied in different countries. The efficiency of board depends on two major factors. One, the competence of the directors and second the hesitation of nominated directors to discuss strategic issues with the board. The activism of institutional investors/individual investors had initiated the board reforms across the countries. In India, the colonial inheritance continued in Indian corporates. A committee constituted by the ministry of finance in its report identified that the better corporate governance in Indian boards is driven by its conscience and not by stakeholders' demands or market forces. The author opines that the nominee directors of financial institutions and mutual funds have ideally planned to perform the role of non-executive directors on company boards.

Generally, the Indian institutional investors have not been observed proactive to enhance the value for the company and its shareholders or prevented the management from taking less optimal decisions or following corporate scandals at a couple of highly respected Indian corporates.

A three-member committee was constituted by Ministry of Finance to look into the current state of corporate governance in India. The findings of the committee were published in the Economic Times Dated 20.10.1996.

The committee has studied the corporate governance system at selected thirty large Indian public corporations. Their inferences were:

- Profits have no relation with the kind of corporate governance model followed in sample companies.

- Directors in most of the companies are found ineffective in monitoring the management's performance.

- Corporates were divided on an issue – whether government should dictate corporate behavior or not.

- Indian corporate sector offers best and worst kind of corporate governance model.
Results show that better corporate governance in Indian boards is driven by its collective conscious and not by stakeholder's demands or market forces.

Other evidences from 'Ownership Structure and Financial Performance: an enquiry into Corporate Governance in Indian Corporates' by Dr. Jiinesh N Panchal\(^4\) (1994) related to corporate performance and shareholding pattern in general and ownership of financial institutions in particular reveals the following:

- Ownership of corporate bodies was found negatively related with growth but positively related with profitability.
- Public ownership also did not show any significant relation with any of the performance variables.
- Financial institutions (FIs) ownership showed significant and positive relation with assets creation.

In yet another study Roy\(^4\) found that the ownership of FIs had negative relationship with profitability. More and more stakeholders are demanding better corporate performance from corporate boards through their limited options. FIs, MFs, regulators and shareholders associations are treading unexplored routes to register protest against corporate boards in India. Draft report of working group on The Companies Act 1956 and Takeover Code 1997 have sincerely attempted to make corporate boards more responsive to the demands of stakeholders. They incorporate provisions that encourage competition in Indian corporate boards. In times to come, if regulator and market support such activism by stakeholders against the self-perpetuating corporate boards, the Indian corporate scene is likely to witness many more cases of stakeholders activism.

The paper by Vinish Kasthuria and Shridhar Dash\(^4\) (1999) investigated the association between board size and corporate financial performance using data on 504 corporations belonging to 18 industries. The results suggested that the size of the board plays an important role in influencing the financial performance of corporations. The analysis showed that the performance improves if the board size increases, but the contribution of an additional board member decreases as the size of the corporation increases. The results, however, fails to indicate any significant role of directors' equity ownership in influencing the performance.
Thus the results suggested that the performance of a corporation depends on its board size. However, the results have been criticized on the ground that the dependent variable used in the analysis, the return on assets for the year would be the same as the shareholder value, if measured in just one year. It is sustained profitability that has an impact on the market value and hence on shareholders wealth. In order to partially offset this criticism, the model has been re-run with the dependent variable defined as average return of three years on assets. The results, however, remain the same in terms of the significance of various variables like board size, director's equity and corporate equity, thus indicating the robustness of the results.

"Institutional Investors and Corporate Governance" by Jinesh Panchali (2002) says that the challenge of promoting enterprise and accountability is common to all markets. What degree of freedom is right for corporate boards and how to make them accountable is a major concern in the realm of corporate governance. Even where market forces are expected to take care of the utilization of available resources, there has to be a system, which ensures that owners of resources are made accountable for their use in the larger interests of the economy.

In the paper the author examined the rationale for institutional investors activism in general and for the Indian capital market in particular, discussed empirical evidences and chalks out the scope and modes of activism. Factors influencing investors' activism, its existing framework, and its experience in the Indian market are also examined. Finally, an alternative approach for evolving a suitable framework for institutional investors' activism in Indian capital markets is suggested.

According to him "Institutions face a free rider problem in initiating activism. While the cost of activism is borne by the institutions, the benefits will be shared by all the shareholders. This acts as a disincentive for institutions to bear the cost of activism individually."

Dr. D.S. Mehta (1997) quotes in Corporate Governance: Role of Professionals "Nine out of ten times when a decision is taken which is not in the best interest of the company the people at the level of the board are fully aware of what they are doing. Professionals also know that correct decisions are not taken as would be expected of agents and trustees but they endorse it either out of compulsion of family arrangements or take it in the best interest of the promoters and make themselves to believe that what is good for promoters management is good for the company. How many of them have given frank opinions to the board about the
proposals that come before it? How many of them have cared to interpret and advice correctly on the law and propriety? How many of them have refrained from finding an easy way out in a situation? If they have cared to do so, have they taken it to logical conclusion?“

Indian Institutional investors normally argue that their responsibility is to manage the portfolio and not the corporate. In contrast, institutions in developed markets who believe in shareholders’ activism argue that their responsibility is to enhance the value of the portfolio they manage.

Several types of interventions by institutional investors have been observed. However, most of these instances seem to be sporadic, crisis-driven reactions rather than actions arising out of a larger policy framework.

It has been empirically observed that their intervention increases shareholders’ wealth. Dr. Mehta concludes that there is a need for a greater debate on the role of institutional investors’ activism in corporate governance. Institutional investors may like to create a collective forum where a larger framework for their responsibility as shareholders may be developed and documented.

Thus a growing body of empirical research has examined the structure and effectiveness of corporate governance mainly in the western context. An important insight from this literature is that corporate governance is influenced by executive compensation, takeover threats, monitoring by the board of directors, and other control mechanisms. The insight is also that if corporate governance becomes less effective, it has an immediate impact on the corporations’ financial performance. The corporate board, with its mix of expertise, independence, and legal power, is a potentially powerful governance mechanism. Being at the apex of the internal control system, it has the final responsibility for the functioning of the corporation.

In UK and US there is adequate research on various aspects of corporate governance and findings have significantly contributed for the reforms in the working of corporate sectors in these countries. In India, however, the research work and remedies found in other countries have little practical utility because of the peculiar phenomenon of family controlled business houses. The problem in Indian context is that it is far easier to change the wrong type of management in case of professionally managed companies rather than in family controlled companies having political clout. The solution to corporate governance problems in India are therefore bound to be different and beyond the solutions found by the experts in the US and UK.
The number of suggestions have been made for improving corporate governance in various write-ups, seminars, meetings etc and these have been well publicised. However majority of these are in the nature of desirable sermons without being backed by practical inputs for implementation. This study aims at providing new empirical evidence on the impact of broad structure, and other governance variables, on corporate performance.

2e. STATEMENT OF PROBLEM

Corporate Governance practices aim at maximization of shareholder value, creation of wealth, increase in the value of business, fulfilment of the Social obligation and welfare of all the share holders.

In India there are some companies, which have voluntarily established high standards of Corporate Governance, but there are many more, whose practices are a matter of concern. There is also an increasing concern about standards of financial reporting and accountability, especially after losses suffered by investors and lenders in the recent past.

There are also many Companies, which are not paying adequate attention to the basic procedures for shareholders service. For example, many of these companies do not pay adequate attention to redress investors grievances such as delay in transfer of shares, delay in dispatch of share certificates and dividend warrants and non-receipt of dividend warrants. While enough laws exist to take care of many of these investor's grievances, the implementation and adequacy of penal provisions have left a lot to be desired. Corporate governance is considered a major instrument for investor protection. To further improve the level of corporate governance, need was felt for a comprehensive approach at this stage of development of the capital market, to accelerate the adoption of globally acceptable practices of Corporate governance. This would ensure that the Indian investors are in no way less informed and protected as compared to their counterparts in the best developed capital markets and economies in the World.

In this context, the Securities and Exchange Board of India (SEBI) set up the Committee on Corporate Governance on May 7, 1998 under the Chairmanship of Shri. Kumaramangalam Birla, member SEBI Board, to promote and raise the standards of the corporate governance. The Birla Committee recommendations have been accepted by SEBI and have been made mandatory for the listed companies through insertion of
Clause 49 in the listing agreement. As per the SEBI press release ref no PR49/2000 dated Feb. 21st, 2000, all the companies included in Group A of the BSE and in S&P CNX Nifty index have to implement all these rules by the end of financial year 31st March, 2001.

At this juncture there is a need to pursue a study to ascertain empirical evidence relating to the governance practices of Indian Companies. There is also a need to find out the feedback and response from Indian Companies to the Birla Committee Recommendations. It is also required to ascertain public opinion on very many issues relating to Corporate Governance on which a code of best practice is yet to be evolved.

In this context, an attempt is made through this study to ascertain the extent of implementation of Clause 49 and the governance practices of Indian Companies. This will help to evaluate the status of acceptance and adaptation of the Birla Committee recommendations by the corporate sector.

2f. OBJECTIVES OF THE STUDY

1. To study the size, structure and composition of Boards of Directors in the corporate units in India.

2. To examine the extent and the manner in which the mandatory as well as the non-mandatory requirements of clause 49 of listing agreement have been adopted by Corporate Units in India.

3. To ascertain the perceptions and views of cross section of the interested groups - directors, professionals and regulatory bodies on specific issues relating to the corporate governance. This is an empirical and analytical study of the governance practices in selected corporate units in India.

4. To analyse the effect of Corporate governance on firm's performance through selected accounting and non-accounting parameters.

2g. METHODOLOGY

2g(i). Period of study

The financial year 2001 was the first year for the companies to implement the rules of Clause 49 of listing agreement. Hence the year 2001 was selected to study the governance practices of Indian Companies.
Corporate Governance helps to maximize the shareholders value in a sustainable fashion in the long run. The profits earned by the company in any one year will not have a reflection on creating the shareholders value. It is the sustained profitability that has impact on the market value and hence on shareholders value. So, for the purpose of financial analysis it is the average performance of the previous 3 years (1998 to 2001) that has been considered.

2g(ii). Selection of Sample

For the financial year 2001, as per the implementation schedule prescribed by the SEBI all the Group ‘A’ Companies of the Bombay Stock Exchange (BSE) and all companies included in the S&P Nifty of the National Stock Exchange (NSE), had to comply with the Corporate Governance mandatory requirements and had to give a compliance certificate to that effect. All the companies seeking new listing also were required to adhere to the SEBI code by the fiscal year April 2001.

As per reports submitted to the SEBI by the respective Stock Exchanges, about 96% of Companies on S&P Nifty and 76% of the Group ‘A’ have complied these requirements by April 2001. The following table gives detailed information in respect of the number of Companies complying.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Type of companies</th>
<th>Total No. of Companies</th>
<th>No. of Companies complying</th>
<th>Percentage of Companies complying</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>BSE - Group ‘A’</td>
<td>141</td>
<td>108</td>
<td>76</td>
</tr>
<tr>
<td>2.</td>
<td>NSE - S&amp;P Nifty</td>
<td>109</td>
<td>104</td>
<td>96</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>250</td>
<td>212</td>
<td>84.08%</td>
</tr>
</tbody>
</table>

Out of the 212 Companies which have implemented the Clause 49, a random sample of 100 Companies was selected to study the governance practices.

2g(iii). Collection Of Data

The required data are collected through the following sources.

1. Secondary Data

The Annual Reports of the Sample 100 Companies for the year 2001, where a special report on Corporate governance has been included were collected through the following sources.
1. From the respective Company website

2. From the stock broking firms.

3. From the libraries of Management institutes like IFMR etc

Apart from the Annual reports, on-line information like quarterly and Half-yearly reports, interviews with CEO's and the financial analysts' reports about the performance disclosed in websites of Companies have been used for the purpose of analysis

For the purpose of financial performance analysis the accounting information of the sample companies for a period of 3 years (covering 1998 to 2001) had been collected from the following sources:

1. Respective Company web-site.

2. India Info line. Com website.

3. The web site of "The Economic Times".

4. Published annual reports of the Companies.

The market prices of the Sample Companies for a period of 3 years had been ascertained from:

1. CMIE package (Center for monitoring Indian Economy).

2. BSE publication on Market prices of Group `A` Company.


2. Primary Data

To examine the perception on Corporate governance, primary data through the Questionnaire have been collected from the following categories of people who are responsible to institute better governance system in the Indian Companies.

a. Company Directors.

b. Company Secretaries.
c. External auditors.

d. Officials of regulatory bodies like SEBI, Stock Exchanges, Registrar of Companies.

e. Analysts from credit rating agencies like ICRA, CRISIL, and CARE who have been involved in the process of rating corporate governance.

Discussions with analysts from credit rating agencies was also helpful and a guiding factor in deciding the rating methodology of Corporate Governance.

2g(iv). Corporate Governance Rating

Corporate Governance deals essentially with qualitative and subjective issues, and therefore is not easily amenable to clear-cut objective analysis. However, quantification is essential for measurement. Corporate governance can be measured by Value imperatives.

Corporate Governance Rating is meant to indicate the relative level to which an Organisation accepts and follows the codes and guidelines of corporate governance practices. Rating process is an assessment of the corporate compliance with statutory regulations as laid out in Clause 49 of the listing agreement. The rating is based on published Annual Reports and disclosures in Company website.

a. Selection of Parameters

An analytical framework was developed taking into account:

i. Clause 49 of listing agreement.

ii. Cadbury Committee recommendations.

iii. The OECD principles.

iv. The code suggested by CII.

Based on the above rules and regulations and on the rating methodology adopted by ICRA, an index consisting of total score of 110 points was developed. This index was inclusive of

a. Mandatory requirements with a score of 64 points.
b. Non-mandatory requirements with a score of 18 points
c. Voluntary investor friendly practices with a score of 28 points

Based on the above rules the following major parameters were selected for rating corporate governance of the Sample Companies:

b. Management discussion analysis.
c. Shareholder's information.
d. Director's remuneration and disclosures.
e. Functioning of various governance Committees like Audit Committee, Share transfer Committee, Remuneration committee etc.
f. Director's attendance in board meetings and AGM.
g. Disclosures in website.
h. Other voluntary practices.

b. **Method Of Scoring And Rating**

Each provision of requirement if adhered was given 1 point in the corporate governance score. However, certain aspects like percentage of director's attending the board meetings and AGM and the composition of independent directors were proportionately given points based on a slab system. (For example: 100% attendance 4 points, 50 to 75% attendance 3 points). The total of this composite score had been taken as the corporate Governance rate of that company.
Having rated the corporate governance practices of the sample companies it has been hypothesized that such companies exhibit better economic performance on an average than other companies. To test this hypothesis the average financial performance over 3 year period has been calculated through the various measures of evaluation. The measures of performance explored in the previous research studies have guided the selection of following financial ratios.

As has been adopted by Paul. W. Macavoy in the Active Board of Directors and its effect on the performance of the large publicly traded corporation the EVA has been used to study the financial performance of the sample companies. EVA is "residual income". It is calculated by subtracting all capital employed in the business from after-tax operating earnings. It represents a company's ability to generate economic profit and thereby create wealth for the shareholders. EVA year after year can be earned only out of good corporate governance.

Economic value added is an absolute measure of shareholders value. But for the purpose of comparing company performance, absolute measures are not meaningful for companies of different sizes. The larger company was identified as the better performer even though its ability to generate larger amounts of economic value added may be a function of size alone rather than superior managerial efficiency. Following the method adopted by Scott. W. Barnhart in "Board Composition, Managerial Ownership, and firm performance: An empirical Analysis", the firm size is controlled with the total assets. Thus to account for the difference in size when evaluating corporate performance, the proportion of economic value added to total assets is calculated.

Return on Total Assets is adopted by John. A Wagner in Board composition and organizational performance- Two studies of Insides/outside effects. The same ratio has been chosen as a measure of organizational performance that explains the pattern of results. It is computed by dividing the profit after tax by total assets.

A report prepared by an investor's forum in Malaysia "Saints and Sinners. Who's got religion?" arrived at a conclusion that better governed companies have higher return on equity. Following the same measure of performance ROE has been computed to assess the value created for the shareholders by the sample companies. It is calculated by dividing the profit after tax by the total shareholders funds including free Reserves.
Earnings per share has been calculated which is a variable adopted by John A Wagner in his research study. McKinsey’s investor’s opinion Report 2000 has concluded that there is a strong correlation between corporate Governance and average share price performance. Following the same to assess the investor’s perceptions and evaluation of the company, the stock performance measure was used as the financial performance indicator. Market prices reflect not only the performance of the company but also investor’s expectations about future performance. Thus, no single year’s operating performance has any strong correlation with the stock returns of that year. Hence, average quarterly market prices have been calculated for 4 quarters in a year. Then annual average prices have been computed for a period of 3 years. Finally three years average price has been considered as a measure of financial performance.

Dividend yield has been computed to assess the shareholders return. It is measured based on dividends and share price appreciation to reflect not only the performance of the company in that period but also changes in the market expectations about future operating and share price performance. Dividend per share together with price appreciation per share is divided by the closing market price for the year to arrive at dividend yield. The 3 year’s average dividend yield has been considered for analysis purpose.

2g(vi). Design Of Questionnaire

Six questionnaires have been drafted to ascertain:

a) Empirical evidence about the various existing Governance practices adopted by the corporate bodies.

b) The opinions in the areas where an accepted code or consensus is yet to be evolved.

Questionnaires to Company Directors and Company secretaries have been issued to find out the current corporate practices on size, structure, composition and functioning of board of directors, board meetings procedures and the functioning of governance committees. Questionnaire to auditors enquires into the functioning of audit committees and desirable practices to improve the governance standards.

Questionnaire to regulatory bodies covers issues relating to ideal board functioning and required area of innovations to improve Governance standards of Indian Companies. The Questionnaires to credit rating agencies covers the issues relating to the methodology of rating the corporate governance.
Another Questionnaire has been drafted and mailed to all the sample companies to ascertain their organizational effectiveness. Company secretaries were required to rate the satisfaction level of the various stakeholders in their company after the implementation of new Governance system and rules. They were also asked to rate the degree of internal effectiveness in their organisations.

Pre - Testing

Pre - testing of the draft questionnaire was undertaken to know the adequacy, relevance and clarity of the contents of the Questionnaire. The Questionnaire was personally administered to 15 executives which included 5 corporate directors, 5 company secretaries and 5 auditors. In the light of the suggestions given by the respondents, few modifications were made and the final questionnaire was then drafted.

The final response for the Questionnaire on organisational effectiveness from the sample companies has been tested for its reliability using Cronbach's Alpha. The value obtained is 0.79 which shows that the instrument is reliable.

2g(vii). Data Collection

Great difficulty was experienced in collecting data from corporate units. Directors are inaccessible, reluctant and evasive in responding to the Questionnaires. Even though attempt has been made to reach all the 100 sample companies to contact their Directors, Company Secretaries and external Auditors, their response was discouragingly low. However through persuasion and personal contacts and visits, the researcher was able to collect reasonable level of response.

The Questionnaire to Directors was sent to 200 Directors of sample companies at the rate of 2 Directors for each company. Companies whose corporate offices are located in Mumbai, Hyderabad, Bangalore and Chennai were contacted personally and others are contacted through mail. The final response for this Questionnaire was 39.

The Questionnaire to company secretaries and external Auditors were sent to all the 100 companies. The response for these questionnaires was 51 from company secretaries and 54 for Auditors. The Questionnaire on organisational effectiveness was sent to all 100 sample units and the response was 25 filled in Questionnaires.
Besides data were collected from the officials of regulatory bodies and the analysts of Credit Rating Agencies. Informal discussions with the officials and analysts were very helpful in rating and assessment of corporate governance.

The final response for the Questionnaires was as follows:

<table>
<thead>
<tr>
<th>a) Company Directors</th>
<th>-</th>
<th>39</th>
</tr>
</thead>
<tbody>
<tr>
<td>b) Company secretaries</td>
<td>-</td>
<td>51</td>
</tr>
<tr>
<td>c) External Auditors</td>
<td>-</td>
<td>54</td>
</tr>
<tr>
<td>d) Regulatory bodies</td>
<td>-</td>
<td>16</td>
</tr>
<tr>
<td>e) Credit rating agencies</td>
<td>-</td>
<td>10</td>
</tr>
<tr>
<td>f) Response from sample companies for the Questionnaire on organizational effectiveness</td>
<td>-</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>-</td>
<td><strong>195</strong></td>
</tr>
</tbody>
</table>

2g(viii). Framework Of Analysis

| a) An Index of Corporate Governance was constructed to rate the sample units |
| b) Mean scores, mean indices, Averages and percentages are used to measure the extent and the manner in which the requirements of clause 49 of listing agreements have been adopted |
| c) Ratio analysis was used for measuring financial performance |
| d) SPSS package (statistical package for social science) was used to study the association between the governance and performance |
| e) Pearson’s co-efficient of correlation was computed and its significance was examined through T-test, to check the relationship between corporate governance rate of a company and it’s financial performance |
| f) A five point scaling technique was used to measure the organizational effectiveness |
| g) F test was applied to examine the differences among companies regarding their performance in relation to their Corporate Governance rating |
The financial year 2001 was the very first year for implementing the Birla Committee Recommendation and clause 49 by the first batch of companies. This year has been selected to study the governance practices of Indian companies. For any new system to get instituted successfully requires sometime. So, also the governance system recommended by Birla committee could not 100% be implemented by the Indian corporates. To this extent, this research study could not be the final word on the quality of governance in Indian companies.

For studying the effect of corporate Governance of firms performance governance practices of sample companies for only one year have been taken into account whereas to measure the corporate performance and find out the sustainable level of profitability, a 3 years period was considered. It would have been ideal to cover the governance practices equally for 3 years (as suggested by ICRA) to come to meaningful conclusions.

The Corporate Governance of sample companies was rated on the basis of limited published information like annual reports and website disclosures. Any good or qualitative practice adopted by the company, which was not disclosed would not have been included for the purpose of rating. However "disclosure & transparency" is the "CRUX" of Corporate Governance. Hence it has been assumed that the companies disclose all the relevant practices for the benefit of investors and the Corporate Governance rate was computed accordingly.

The study examines the relationship between Corporate Governance and firm’s performance by computing coefficient of correlation. However the correlation analysis doesn’t establish cause and effect relationship Therefore it can not be interpreted that better governance leads to better performance.

A five point scaling technique was used to measure the organizational effectiveness. As the companies self rate their organizational effectiveness there is bound to be some positive bias in their responses. Therefore their responses are grouped under two categories-high and low only by taking extreme positive response as high and all others as low.
f. Even though attempts are made to contact all sample companies with Questionnaires for different categories of respondents, the response rate was discouragingly low. So no attempt has been made to generalise the findings.

g. Even though Questionnaires have limitations in getting reliable and accurate data, considering the nature of the study and the locational dispersal of corporate units only this method of data collection is considered suitable.

2h. CHAPTERIZATION

The Thesis has been presented with the following chapter arrangement:

Chapter I explain the Corporate Governance practices across the countries in the world, list out important provisions from the codes of best practice given by the committees on Corporate Governance.

Chapter II highlights the conceptual and contextual significance of Corporate Governance, and presents the detailed research methodology adopted in the work. It also presents detailed review of literature covering the studies both in India and abroad.

Chapter III presents an evaluation of Corporate Governance practices of Indian companies. In particular the extent and the manner of implementation of Governance system suggested by Clause 49 of listing agreement was analyzed.

In chapter IV corporate governance rate was computed for sample companies and the hypothesis that good governance is significantly and positively related to firm's financial performance is tested.

Chapter V presents the empirical evidence collected from the research survey through the Questionnaire on Corporate Governance Practices. It also highlights the perceptions of the different groups of people on the concept of Corporate Governance throwing light on the areas, which are needed to improve for incorporating better Governance.

Chapter VI provides a summary of findings, suggestions and conclusion.
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