CHAPTER – 01

INTRODUCTION
1.1 Corporate Governance

In the last few decades, the awareness on matters relating to Corporate Governance increased significantly which is mainly brought by financial market reforms, globalization and also due to phenomenal transformation of business process brought by communication and technological revolution. Hans W Decker (2003) was of the view that Globalization is a principal driving force for corporate governance. With the liberalization of the economy, legislation and regulation of capital market, training and development and also recruitment and selection of director and the academic research etc have opened up a number of avenues of interaction on law makers, chamber of commerce, among others on government policies and practices all over the world.

Corporate tragedies in the last few decades such as Xerox, WorldCom and Enron etc that committed deliberate frauds with a view to boosting their sales revenue and highly inflated profit, had serious impact on shareholder value. On the other hand, investor on their part can neither equate high profits shown by their company as a sure index of corporate efficiency nor treat a company’s failure to maintain a consistent high profit as a failure of corporate governance. This further has led to a searching question on the very legitimacy of purpose of modern corporations, as these failures betrayed shareholders.

Organization and Management are inseparable because success of an organization is invariably supported by its strong management. However, there is an agency
problem and the potentially conflicting interests of managers and shareholders have been in the forefront of research in accounting and finance at least, since Jensen and Meckling (1976) pioneering work. Nevertheless, they go hand in hand and further more what determines success or efficient management is an important area that needs to be studied in depth. With globalization and liberalization, there is an increasing expectation among the masses of quality goods and services. But still there remain loopholes/lacunae on the part of firms in delivering such goods and services. The important contributing factor is its weak and inefficient management. As the trees attain its height so should its roots be strong and firm enough to support it against collapsing. Similarly, as a firm expands and grows, it needs to be supported by a strong and efficient management to withstand against any undesirable odds in future events. Realizing the same business entities today are increasingly giving attention to its proper management which then gave birth to corporate governance. One of the prime objectives of every firm is to increase and maximize its profit while protecting the interest of its participants. The ability of firm to meet its objective is through corporate financial performances which further foster the economic growth of the country. Moreover, firms being the blood of the economy can paralyze the economy of the country as a whole if it performs negatively. Thus corporate governance, a “system by which business corporations are directed and controlled” came into limelight. The board of directors being the key player is typically central to corporate governance, other being the shareholders, management and stakeholders viz, employees, customers,
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suppliers, and creditors. The corporate governance also has to take into account the legal, regulatory, institutional and ethical environment of the community. Corporate success and sustainable economic growth rest with good governance. A firm which has good governance system has better image and greater value, higher profits and higher sales growth than those with poor governance system (Paul et al. 2003). Furthermore, corporate governance will promote enterprise and ensure accountability. The attributes of good governance: equity, fairness, transparency, accountability, honesty, secularism and a robust, consistent and responsive legal system. N. R Narayana Murthy (2014). Different countries follow different models of corporate governance depending upon their environment, cultural background etc. The importance of corporate governance had not been felt and practice in the past until the economic crisis hit many parts of the western and Asian countries. The current wave of reform of Corporate Governance commenced with the Cadbury code of practice published by the London Stock of Exchange in 1992. Corporate Governance has now become the subject of intense debate in the background of the recent scam involving the world’s leading firms that include Enron, WorldCom, Xerox and others and has become a mainstream issue and subject of discussion for boardroom, academia circles, government and regulators. These incidents highlighted the importance and status of corporate governance the world over. In effectual, poor corporate structure increase the risk of fraud, corporate failure or both. Further, with the wave of globalization, mergers and acquisition, there is an increasing competition where only the strong survive,
brought the corporation towards better governance system. Corporate Governance concerns the exercise of power in corporate entities and has wider implications and is critical to economic and social well-being, firstly, in providing the incentives and performance measures to achieve business success, and secondly in providing the accountability and transparency to ensure the equitable distribution of the resulting wealth. Thus the quantity, quality and frequency of financial disclosure, accountability, transparency in corporate functioning for maximizing shareholders wealth are the progressive elements and indeed the underlying spirit of corporate governance. Failure in Corporate Governance is a real threat to the future of every corporation and to the economy, therefore the weakness of corporate should be tackle and assess for healthy future.

Many countries that suffered during the recent economic crisis in Asia and other emerging markets had weak legal environments and poor governance systems (Joh, 2003). Countries with weak governance system (weak legal Protection) suffer from greater exchange rate depreciation and sever stock market decline. So is the case for individual firms. A firm with weak governance mechanism is likely to be more affected by the stock market valuation which has negative impact on both firm and the country’s economy. In the past few years, corporate governance has become a popular area of discussion in the academia and business community. Having been a topic of academic research for a long time in the Anglo-Saxon literature, corporate governance has only recently moved from a special interest into all sections of the corporate sector and the political scene (Drobetz, 2003).
There are three principal drivers for an increased demand for good corporate governance (Drobetz, 2003). First, the institutionalization of shareholdings, where the institutions are providers of capital and put pressure either by selling shares of those firms that do not follow internationally recognized corporate governance standards ("Wall Street Walk") or by exercising direct control over the incumbent management of the respective firms ("Voice"). Second is the need for convergence of international and national corporate governance; i.e., firms with international operations is still subject to national corporate governance from a judicial perspective. Finally, the recent corporate collapses give reasons to believe that a firm's valuation does not only depend on the profitability or the growth prospects, but also on the effectiveness of control mechanisms. Corporate governance has recently received much attention due to Adelphia, Enron, Parmalat, Tyco, WorldCom and other high profile scandals (Brown and Caylor, 2004), serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years (Byrnes et al., 2003).

It's a common belief that only more stringent laws and regulatory controls can prevent management self-interest and expropriation of outsiders and alleviate governance malfunctions In general. But beyond a legal point of view corporate governance is important specifically from asset pricing point of view. The market for corporate control (Mergers and Acquisitions) is a self regulatory force to
discipline the undisciplined managers for a subsequent increase in firm value and performance (Martin and McConnell, 1991). This goes with the growing conviction that better corporate governance leads to higher shareholder value. The logic behind this is that better corporate governance, with adequate disclosure and transparency standards in place, reduces the agency costs’ leading to a reduction in the required rate of return of investors and, therefore, a firm’s cost of capital. To sum up the capital market rewards companies with good governance practices and punishes bad ones.

In the present day integrated world capital markets where no transaction or agency costs of external finance, the traditional Capital Asset Pricing Model (CAPM) predicts that expected returns on equity only depend on the level of covariance risk with the world market portfolio, and corporate governance related differences between countries or individual firms should have no explanatory power (Drobetz, 2003). However, in the presence of agency problems, the induced agency costs ought to be important for explaining the cross-section of expected stock returns (Drobetz, 2003). In fact, there is now a growing body of literature that shows evidence for the relationship between corporate governance and firm valuation.

1.2. Governance and Performance – Theories and Evidences

From among the internal (Firm Specific Governance) and external mechanism (Market for Corporate Control) most of the previous literature focus on internal mechanism than external. A number of research studies on corporate governance
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examine the efficacy of alternative structures for the board of directors and alternative ownership structures. While there is mounting evidence of the failure of certain governance structures to motivate managers to increase firm performance, the empirical evidence to date is mixed and gives little coherent evidence for the shape of an optimal governance structure (Core et al., 1999).

Further, the literature on governance and performance can be segregated into two broad categories as (i) Organization Monitoring Mechanism and Performance and (ii) Chief Executive Officer (Hence forth CEO) Incentive and Performance. Within this broad category of monitoring mechanisms, the studies are based on three types of devices that firms may choose to implement to monitor the CEO, which are Leadership Structure (Separation of CEO and Chairman of Board); Composition of Board of Directors (Hence forth BOD); and Ownership Structure (Coles, Mcwilliams and Sen, 2001). In the second category, the prior works basically concentrate on Performance contingent pay and Ownership stake in the firm. In the following lines a comprehensive review of theory and evidence relating to each facet of governance mechanism is outlined. Since the literature on corporate governance is a jungle, looking at the niceties the literature of first category is reviewed in the following pages.

1.3. Corporate Governance in context to India:

In the context of developing countries, corporate failures compounded the problems of relatively underdeveloped capital market and also made regulatory
reforms for industrial development complex. This has been added by lack of industrial and trade policies, absence of competitive policies and market failure among others.

The process of industrializations in developing countries like India was accelerated with the opening of the economy in the 1990's. However, there are numerous market imperfections, industrial practices and policy. The need for corporate governance was first realized in the country with 'Big Bull', Harshad Mehta scam in April 1992, involving a large number of banks and resulting in stock market crash for the first time since reforms in 1991. This was followed by a case in 1993 when transnational companies consolidating their ownership by issuing equity allotment to their respective controlling groups at a discount to their market price. This was followed by many other scams such as Videocon, Sterlite and Ketan Parekh scam (2001). The more recent being the Satyam (IT) scam (2009) which show an inflated profit audited by Pricewaterhouse Coopers.

Indian industries comprises of Public and Private sector as well as government companies with different ownership pattern. Government-Owned Enterprises (GOE) still represents a substantial part of GDP, employment and market capitalization. Moreover, Government - Owned Enterprises are often prevalent in utilities and infrastructure industries, such as energy, transport and telecommunication, whose performance is of great importance to broad segments of the population and to other parts of the business sector. Consequently, the
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governance of GOEs will be critical to ensure their positive contribution to a country’s overall economic efficiency and competitiveness. On the other hand, the Indian companies is mainly dominated by family ownership and this private firm are prevalent in services, transport as well as manufacturing industries and has a strong impact on the performance of the economy of the country which therefore is necessary to bring them under the same governance code.

1.4. Historical Background:

The Companies Act 1956 was enacted on the recommendations of the Bhaba Committee set up in 1950 with the object to consolidate the existing corporate laws and to provide a new basis for corporate operation in independent India. With enactment of this legislation in 1956, the Companies Act 1913 was repealed. The Companies Act, 1956, has since provided the legal framework for corporate entities in India. The need for streamlining this Act was felt from time to time as the corporate sector grew in pace with the Indian economy, with as many as 24 amendments taking place since 1956. Major amendments to the Act were made through Companies (Amendment) Act, 1988 after considering the recommendations of the Sachar Committee, and then again in 1998, 2000 and finally in 2002 through the Companies (Second Amendment) Act 2002, consequent to the report of the Eradi Committee.

Many countries faced with the task of economic restructuring in response to the realities of a changing economic environment, have undertaken comprehensive
revisions of their respective corporate laws. UK Companies Act was revised during the 1980s. Subsequently, many countries whose legal systems were derived from UK, such as Australia, New Zealand, Canada etc also undertook reviews of their corporate laws and brought about several comprehensive reforms. It is widely accepted that reform and updating of the basic legal framework for corporate entities is essential to enable sustainable economic reform.

After a hesitant beginning in the 1980s, India took up its economic reforms programme in the 1990s. Equally, a need was felt for a comprehensive review of the Companies Act, 1956. Unsuccessful attempts were made in 1993 and 1997 to replace the present Act with a new law. Companies (Amendment) Bill, 2003; containing important provisions relating to corporate governance was also introduced, the consideration of which has been held back in anticipation of the comprehensive review of the Company Law. While piecemeal reform continued through amendments, it has not yet been possible to bring about comprehensive, new legislation to replace the existing Act.

In the current national and international context, there is a requirement for simplifying corporate laws so that they are amenable to clear interpretation and provide a framework that would facilitate faster economic growth. It is also increasingly being recognized that the framework for regulation of corporate entities has to be in tune with the emerging economic scenario, encourage good corporate governance and enable protection of the interests of the investors and
other stakeholders. In the competitive and technology driven business environment, while corporate require greater autonomy of operation and opportunity for self-regulation with optimum compliance costs, there is a need to bring about transparency through better disclosures and greater responsibility on the part of corporate owners and managements for improved compliance. It is appreciated that the Government has taken up this fresh exercise for a Comprehensive revision of the Companies Act 1956 on the basis of a broad based consultative exercise. As a first step in this consultative process, a Concept Paper on Company Law drawn up in the legislative format was exposed for viewing on the electronic media so that all interested may not only express their opinions on the concepts involved but may also suggest formulations on various aspects of Company Law. Comments and suggestions from a large number of organizations, professional bodies and individuals not only allow ideas, comments and suggestions to flow in from all quarters, but will also enable the Government to work out appropriate legislative proposals to meet the requirements of India's growing economy in the years to come.

The Government, therefore, felt it appropriate that the proposals contained in the Concept Paper and suggestions received thereon be put to merit evaluation by an independent Expert Committee. This results in the setting up of Committee like J. J. Irani Committee, constituted on 2\textsuperscript{nd} December, 2004, Malegam Committee, Narayana Murthy Committee and Naresh Chandra Committee.
1.5. Need For Governance

Just as Democracy is of the people, by the people and for the people, so is also a corporate entity which is of the society, by the society and for the society. Similarly as a state is run and manage and controlled by the people, so is also a company being a corporate entity is also controlled, managed by the elected Board of Directors who are elected by the stakeholders and shareholders. The BOD who is the agents of the shareholders has the responsibility to govern in a transparent manner as well as protecting the interest of the shareholders. Moreover, a Company BOD and the management should work within the framework of its Memorandum and Articles of Association. The functions should also confirm with generally acceptable ethical standards and also the primary objectives should to meet the social responsibility. Corporate Governance being governing the affairs of the company would signify a code of conduct to be observed by a corporate entity which is reflected through the actions of BOD. This code of conduct is to be observe in order to protect the interest of the shareholders and stakeholders. Again, for the prosperity of the economy, it is the corporate entity which assists in the growth of wealth of a country. A corporate entity being able to have a perpetual life has been able to separate ownership from management, attract capital with limited but with maximum returns and thus initiate creation of wealth of a community. Further, it is this separation which give rise to the need that the management should be properly supervised and that they should be accountable to the owners who had stake in the company, should observe and
follow ethical standards in its dealing and should keep informed all the interested parties. If there is proper governance, it will result in the best yield-value additions to owners and security of lenders. Therefore the importance of good Corporate Governance in the present globalised economy for creation and preservation of wealth cannot be over emphasized. Ensuring for a long term sustainable growth there is a need to adhere to the standard of corporate governance.

The main purpose of this study is to survey the governance practices of corporate sector in India and to suggest ways and means to improve upon the existing practices. The purpose of this chapter is to set out the "statement of the problem", 'purpose' and 'scope' and 'methodology of the present research work have also been enumerated.

For effective management and control of any enterprise whether it is a private or public concern, there are basic measures which are necessary and to properly control any organisation there must be adequate governance structures and protection of shareholders through timely presentation of corporate information. For which, Accounting information is especially essential for proper financial and economic control. Accounting information of corporate sector provides information for managerial operation and for reporting to higher authorities. The health of the corporate sector in India and the major part of our industrial economy has come to depend on how well government company are operating and managing their finances.
1.6. Importance of the Study:

The need and importance of corporate governance had swept many parts of western and some Asian countries during mid 1970. Corporate governance is a new name, and it has not been long that has come to India. The wave of corporate governance has hit India in the 1990’s and since then the importance has spread like wild fire and many studies have also been conducted. But these studies do not study the problem entirely and there is a need to study the linkages between governance and its performance in the corporate sector.

A large number of studies have also been conducted in different countries to meet the changing scenario of different aspects of an organization. No doubt, there are many organizations with poor governance and high profits but there are large number of firm which are either sick or closed down since they cannot function efficiently. A study of corporate governance as a determinant of corporate performance in a resource crunch economy like India would be of great interest and importance.

Many countries around the globe are infected with a series of high profile corporate failures, frauds and malpractices in some of the renowned companies. The Korean financial crisis and many more can be attributable to poor corporate governance. So it is also important to find out the loopholes and drawbacks, and to suggest measures to improve the managerial efficiency so that expensive corporate failure can be avoided in future. The study of corporate governance has important
public policy implications relating to the role of government and the markets in disciplining management.

The research work would gain importance by *proposing a framework for examining the impact of a package of governance mechanisms; considering both market and accounting measures of performance; and by confining itself to a cross-section of companies within a single jurisdiction*, which have been the major limitations of the earlier studies.

1.7. Research Problem

Most of the prior literature focuses on the impact of governance on various organizational outcomes taking individual governance mechanism into consideration, which suggests that individual governance mechanisms are independent of each other. In reality they are interdependent, for example CEO compensation is higher when the CEO is also the board chair, the board is larger, there is a greater percentage of the board composed of outside directors, and the outside directors are appointed by the CEO or are considered “gray directors” (Core et al., 1999). Hence there *is a need for examining the impact of a package of governance mechanisms (Monitoring mechanism and Incentive Mechanism) on performance*.

Unfortunately, most of empirical works examine the relationship of governance and performance under different legal environment, hence analyze the impact of
different corporate governance practices in a cross-section of countries (Drobetz, Schillhofer and Zimmermann, 2004) but a cross-sectional, time-series country analysis can be more advantageous than cross-country analyses. Hence an investigation of whether differences in the quality of firm level corporate governance also help in explaining firm performance in a cross-section of companies within a single jurisdiction, would add fabulous value to the existing literature.

The study of Corporate Governance is also important in the context of disciplining the undisciplined management. Those proposing government intervention in corporate governance argue that there is a positive relationship between the use of effective governance vehicles and firm performance. Therefore, proper governance structures should be mandated through law. Opponents of government intervention mainly argue that each firm has different governance needs depending on its economic and regulatory environment, as well as exogenously determined market forces that may also discipline management. Because of this, imposing a governance structure on a firm may lead to monitoring that is both redundant and costly, and will not necessarily improve firm performance. Ultimately, the relationship between the various characteristics of corporate governance and firm performance is an open empirical question.

Most of the empirical studies so far have analyzed the impact of governance on performance have concentrated on developed economies and a very few on
emerging markets. Since the legal, political and economic environment of developing countries varies significantly from developed countries there is a need to throw some more lights on the relationship between governance and performance in emerging markets like India.

From among the studies discussed so far, those which examined the shareholders return found no significant distinction between the performance of firms with and without good governance, while some others which used accounting based measures found that firms with better governance mechanism outperformed others. Some studies found little evidence to support a performance distinction between better and poor governed firms, by using Market Value Added (MVA) and Economic Value Added (EVA) as performance measures. The mixed and conflicting results with different performance measures necessitates for a comprehensive study in the Indian context considering both the market and accounting measures of performance to have some conclusive evidence.

1.8. Objectives of the Study:

Given the importance of the research problem to the field of corporate finance and for resolving the inconsistent research findings as described earlier in the literature review, the present study would make an attempt to re-examine the relation between governance and performance of firms in the Indian context. The following objectives are to be looked into in the research work.
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➢ To find whether or not firm-level differences in Corporate Governance matter for performance, market valuation, and access to external financing.

➢ To study the relationship between firm level governance and profitability

➢ To study the relationship between firm level governance and cost of capital

➢ To study the relationship between firm level governance and market return of the firm

➢ To examine whether there is any association between individual governance mechanism (Leadership Structure, Ownership structure, Outsider Representation and Compensation) and the quality of firm performance.

➢ To uncover the effect of leadership structure, separation of CEO and chair of board, on the performance of the firm.

➢ To study the effect of ownership structure on firm value. To examine whether differences in ownership structure at the firm level can explain differences in firm performances.

➢ To examine the effects of the presences of outside directors in the corporate board structure that impact performances.
1.9. **Research Methodology:**

It is proposed that the information relating to Board of directors, ownership structure, and their financial statements shall be collected through secondary source. The market return would be collected from the website of Bombay Stock exchange. Further books, journals, publication of CII and other related literature would be considered wherever necessary.

Companies are to be ranked on the basis of their governance score. Governance Score can either be developed or Governance score developed by other agencies like Business today (BT) or Institute of Company Secretaries of India (ICSI) can be used. Governance score would be the sum of the binary figures assigned to companies on the basis of some governance factor, which are to be found out from prior literature.

One hundred sixty three companies representing different size across industries are to be considered for the study as more than that would be difficult to manage for a clinical exploration. The companies to be chosen must be listed Indian companies irrespective of their boundaries confined to India or abroad. An attempt would be made to incorporate companies of all size; large, small and medium based on their total assets.

Different performance measures spread across three categories: operating performance, valuation and shareholder payout are to be used in the study.
Operating performance would be measured through return on equity, profit margin and sales growth. Tobin’s Q, the single valuation measure considered by economics, finance and law researchers would also be used in the study. Dividend yield would be used for examining the shareholder payout. *Industry adjusted measures are to be calculated to control for the variables affecting the industry performance systematically.*

Two types of cross sectional analysis will be carried out. First correlation analysis will be done between score and industry adjusted performance. Then Companies are to be ranked on the basis of their governance score (from top to bottom) and the difference of performance between two extreme quartiles will be found out to establish the relationship. ‘t’ test is to be used for determine the statistical significance of the difference.

To assess which categories and factors are associated with good/bad performance, regression analysis is proposed with different performance measures as dependent and individual governance mechanism as independent factors.

**1.10. Chapter Plan:**

The second chapter consist of survey of literature where governance mechanism such as-leadership structure, composition of board of director, ownership structure and remuneration of CEO are reviewed. Further, other related mechanism are also encompassed on the study with their different views on the governance system.
The third chapter consists of analyzing the governance mechanism and corporate performance. All types of listed companies irrespective of size are taken for the study and segregation to be made in respect of manufacturing, services, and investment institutions and so on. The governance mechanism and governance practices of each company is to be study and compare with the corporate performance of each Company and correlation analysis is to be done to find out whether governance contribute for better performance or whether performance is negatively correlated. The fourth chapter will be an analysis of different governance mechanism of different corporate entity and correlating with the respective corporate performance. Each individual governance mechanism has to be studied and results to be drawn and find out which governance mechanism has contributed most for the corporate performance. The last chapter consists of conclusion and finding of the study and certain recommendation. Hence, the chapterisation will consist of the following:

Chapter – I Introduction
Chapter – II Corporate Governance: Theory and Evidence
Chapter – III Determinants of Corporate Governance for Indian Firms
Chapter – IV Corporate Governance and Firm Performance
Chapter – V Governance Mechanism and Firm Performance
Chapter – VI Summary & Conclusion
References


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