CHAPTER - 03

DETERMINANTS OF CORPORATE GOVERNANCE FOR INDIAN FIRMS
3.1 Introduction:

Corporate Governance has recently received much attention due to Adelphia, Enron, WorldCom, Satyam, and other high profile scandals, serving as the impetus to such recent regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulations in the past 70 years. (Byrnes et al. 2003). If better corporate governance is related to better firm performance, better governed firms should perform better than worse governed firms.

Managers have incentives to expropriate a firm's assets by undertaking projects that benefit themselves personally but that impact shareholder wealth adversely. (Jensen and Mackling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1997). Effective corporate governance reduces control rights stockholders and creditors confer on managers, increasing the probability that managers invest in positive net present value projects. (Shleifer and Vishny, 1997), suggesting that better governed firms has better operating performance.

Regulators and governance advocates argue that the stock price collapse of such former corporate stalwarts as Adelphia, Enron, Parmalat, Tyco, and WorldCom, Satyam, was due in large part to poor governance. If their contentions are valid, a market premium should exist for relatively well governed firms. Gompers et al. (2003), Bebchuk and Cohen (2004) and Bebchuk, Cohen and Ferrell (2004) show that firms with stronger stockholder
rights have higher Tobin Q’s, their firm value, suggesting that better governed firms are more valuable.

The free cash flow hypothesis (Jensen 1986) maintains that firm’s shareholders where control lies mostly with managers are less likely to receive free cash flow via cash dividend payouts. Larger free cash flow payouts reduce manager’s abilities to invest in value destroying projects such as capital expenditure and acquisitions possessing negative net present values. Consistent with the notion those earnings are retained for empire building rather than for engaging in positive net value projects. Arnott and Asness (2003) find that firms with relatively smaller dividend payouts have relatively lower earnings, growth suggesting that better governed firms pay out more cash to shareholders.

A 28 factor summary metric develop, that is more highly associated with expected firm performance than is the off used 24 factor G – Index derived by Gompers, Ishii and Metrick (2003).

3.2. Review of Related Research:

It is often alleged that boards of directors are more independent as the proportion of their outside director’s increases (John and Senbet, 1998). However, Forsberg (1989) finds no relation between the proportion of outside directors and various performance measures (i.e., SG & A expenses, sales number of employees and return on equity); Hermalin and Weisbach (1991) find no association between the proportion of outside directors and Tobin’s Q;
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and Bhagat and Black (2002) find no linkage between the proportion of outside directors and Tobin's Q, return on assets, assets turnover and stock returns. In contrast, Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) show that the market rewards firms for appointing outside directors. Brickley, Coles and Terry (1994) find a positive relation between the proportion of outside directors and the stock market reaction to poison pill adoptions and Anderson, Mansi and Reeb (2004) show that the cost of debts as proxied by bond yield spreads is inversely related to board independence.

Thus, the relation between the proportion of outside directors, a proxy for board independence and firm performance is mixed. Studies using financial statement data and Tobin's Q find no link between board independence and firm performance, while those using stock returns data or bond yield data find a positive link. Consistent with Hermalin and Weisbach (1991) and Bhagat and Black (2002), we do not find Tobin's Q to increase in board independence, in fact, we find the opposite, but we do not find that firms with independent boards have higher returns on equity, higher profit margins, larger dividend yields and larger stock repurchases, suggesting that board independence is associated with other important measures of firm performance aside from Tobin's Q.

Limiting board size is believed to improve firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision making of larger groups (Lipton and Lorsch 1992; Jensen1993). Consistent with this notion, Yermack (1996) documents an
inverse relation between board size and profitability, asset utilization and Tobin's Q. Anderson et al (2004) show that the cost of debt is lower for larger boards, presumably because creditors view these firms as having more effective monitors of their financial accounting processes.

Klein (2002) documents a negative relation between earnings management and audit committee independence and Anderson et al (2004) find that entirely independent audit committees have lower debt financing costs. Frankel, Johnson and Nelson (2002) show a negative relation between earning's management and auditor independence, base on audit versus non audit fees, but Ashbaugh, Lafond and Mayhew (2003) and Larcker and Richardson (2004) dispute their evidence. Kinney, Palmrose and Scholz (2004) find no relationship between earning restatement and fees paid for financial information systems design implementation or internal audit services, and Agrawal and Chadha (2005) find no relation between either audit committee independence or the extent auditors provide non audit services with the probability a firm restates its earnings.

Several studies have examined the separation of CEO and chairman, positioning that agency problems are higher when the same person holds both positions. Using a sample of 452 firms in the annual Forbes magazine rankings of the 500 largest U. S. public firms between 1984 – 1991, Yermack (1996) shows that firms are more valuable when the CEO and Board chair positions are separate. Core, Holthausen and Larcker (1999) find that CEO compensation is lower when the CEO and board chair positions are separate.
Botosan and Plumlee (2001) find a material effect of expensing stock options on return on assets. They use Fortune's list of the 100 fastest growing companies as of September 1999, and compute the effect of expensing stock options on firms operating performance. Based on Fortune 1000 firms during 1997 - 1999, Fich and Shivdasani (2004) find that firms with directors stock option plans have higher market to book ratios, higher profitability as proxied by operating return on assets, return on sales and asset turnover and they document a positive stock market reaction when firms announce stock option plans for their directors.

Gompers, Ishii and Metrick (2003) use Investor Responsibility Research Centre (IRRC) data and conclude that firms with fewer shareholder rights have lower firm valuations and lower stock returns and classify twenty four governance factors into five groups and most of these factors are anti takeover measures so G–Index is effectively an index of anti takeover protection (Cremers and Nair 2003) rather than a board index of governance.

Firm performance was measured using two accounting measures and one market based measure. Return on Assets (ROA) and Return on Equity (ROE) were chosen as they were common accounting measures used by the investment community to assess firm performance and are among the most widely used variables to measure firm performance in empirical research Capon et el 1996; Davis et el 2000. However in addition to traditional accounting measures of performance, Market value Added (MVA) was also included as it is a measure that captures relative success of firms in
maximizing shareholder value through the efficient allocation and management of scarce resources (Sten Stewart 1996). MVA is defined as market value (number of shares outstanding * share Price) - capital (Debt and Equity) employed in the firm. Thus, we captured relevant indicators of performance in that both traditional internal accounting measures as well as measures of market based performance were analyzed.

3.2.1. Ownership:
We investigate whether differences in the quality of firm level corporate governance also help to explain firm performance in a cross-section of companies within a single jurisdiction whether a firm’s ownership structure affected its performance.

This study examines the performance of firms operating with the same legal institutions, corporate governance environments, macro- and developmental economic stages, accounting standards, etc. Firms in the same country face the same legal protection and institutional constraints, or lack thereof; so a country analysis can avoid the endogeneity problems between ownership structure and institutional environments.

The connection between ownership structure and performance has been the subject of an important and ongoing debate in the corporate finance literature. The debate goes back to the Berle and Means (1932) suggests that an inverse correlation should be observed between the diffuseness of
shareholdings and firm performance. Their view has been challenged by Demsetz (1983) who argues that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market for shares.

The empirical studies about the relation between both variables seem to have yielded conflicting results. Demsetz and Lehn (1985) provide evidence of the endogeneity of a firm's ownership structure argued for by Demsetz (1983). And also assess the validity of the Berle and Means thesis: A linear regression of an accounting measure of profit rate on the fraction of shares owned by the five largest shareholding interests and on a set of control variables, in which ownership structure is treated as an endogenous variable, gives no evidence of a relation between profit rate and ownership concentration.

Morck et al. (1988) ignore the endogeneity issue altogether and re-examine the relation between corporate ownership structure and performance. Like Demsetz and Lehn (1985), they find no significant relation in the linear regressions they estimate using Tobin's $Q$ and accounting profit rate as alternative measures of performance.

3.2.2 Audit Committee

An audit committee is a key institution in the context of corporate governance which helps the board of directors in fulfilling their financial
and fiduciary responsibilities to shareholders. Clause 49 of the listing agreement read with section 292A of the companies act lays down the provisions for constitution of an audit committee. The audit committee is a sub-committee of the board which plays a key role in corporate governance. It is for enabling the directors to discharge their responsibility, particularly in relation to financial reporting, integrity, internal control, risk management and corporate standards of behavior.

It is hypothesized that the practice of earnings management is systematically related to the strength of internal corporate governance mechanisms, including the board of directors, the audit committee, the internal audit function and the choice of external auditor. Strong governance involves balancing corporate performance with an appropriate level of monitoring (Cadbury, 1997). We explore the relationship between governance mechanisms and performance of firms in BSE 200 and, hence, our focus is on the monitoring role of governance. The mechanisms we examine is an effective audit committee (Menon and Williams, 1994)

Based on a broad cross-sectional sample of 434 listed Australian firms, for the financial year ending in 2000, a majority of non-executive directors on the board and on the audit committee are found to be significantly associated with a lower likelihood of earnings management,
as measured by the absolute level of discretionary accruals (Davidson et al. 2005). We extend this research by exploring the effect of additional audit committee variables such as size and frequency of meetings as well as the independence of members.

3.2.3. Remuneration Committee:

Besides the audit committee, the remuneration committee is most commonly mandated by the corporate governance codes applicable to listed firms across nations. Cerbioni and Parbonetti's (2007) remark that it is the involvement of independent directors on board-appointed committees rather than their mere representation on the board that leads to a sound corporate governance system.

Early studies in the UK indicate that there is no association between remuneration committees and management pay, in an era where the highest paid executives are usually members of the remuneration committee (Main and Johnston, 1993). Since the publication of the Cadbury report in 1992, which made recommendations on corporate governance risks and failures, Conyon and Peck (1998) demonstrate that among other things, the remuneration committee has established transparency in setting the remuneration of senior executives. They find that the presence of a remuneration committee with independent directors enables UK firms to align management compensation with firm
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performance. Using panel data on large, publicly traded U.K. companies gathered between 1991 and 1994, we examined the role of board control and remuneration committees in determining management compensation. Board monitoring, measured in terms of the proportion of nonexecutive directors on a board and the presence of remuneration committees and CEO duality, had only a limited effect on the level of top management pay. An important conclusion was that top management pay and corporate performance are more aligned in companies with outsider-dominated boards and remuneration committees.

3.2.4. Grievance Committee:

In terms of Clause 49 – IV (G)(iii) of the listing agreements, Grievance Committee shall be formed under the chairmanship of a non executive director to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non receipt of balance sheet, non receipt of declared dividends.

References


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