CHAPTER – 06

SUMMARY

AND

CONCLUSION
6.1. Summary & Findings:

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 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; hence the study of corporate governance has important public policy implications relating to the role of government and the markets in disciplining management.

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. Hence there is a need for examining the impact of a package of governance mechanisms (Monitoring mechanism and Incentive Mechanism) on performance. Further, most of empirical works examine the relationship of governance and performance under different legal environment, hence they analyze the impact of different corporate governance practices in a cross-section of countries 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.
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. 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.

In view of the above and to add to the existing stock of knowledge in this discipline of finance, the current research work makes an attempt to examine the impact of a package of governance mechanisms on both market and accounting measures of performance by confining itself to a cross-section of companies within a single jurisdiction of India. Given the importance of the research problem to the field of corporate finance and for resolving the inconsistent research findings in the prior literature, the relation between governance and performance of firms have been looked into with help of the following objectives:
> Finding whether or not firm-level differences in Corporate Governance matter for performance, market valuation

> Studying the relationship between firm level governance and profitability

> To study the relationship between firm level governance and market value of the firm

> Examining the association between governance practices at firm level with their respective performance

> Identifying the cause and effect relationship between individual governance mechanism (Board process and structure, Ownership structure, Audit committee, Remuneration committee and grievance committee) and the firm performance.

For carrying out the above objectives, the corporate governance information relating to Board of directors, ownership structure, Audit committee, Remuneration committee and grievance committee and their financial statements are collected through secondary source. Different performance measures spread across three categories: operating performance, market value added and shareholder payout are used in the study. Operating performance would be measured through return on equity, profit margin and sales growth. To represent the market value added, the study used P/B ratio that are collected from the website of Bombay Stock exchange. P/B is in fact the single MVA measure considered by economics, finance and law researchers. Further the performance measures like EBITDA margin, ROE, Sales growth are collected from the PROWESS (CMIE) data base.
Dividend payout ratio is also considered in the study. Several theories have been put forward to explain the information that dividend pay-out might convey, most prominently the cash flow signaling and the free cash flow hypotheses. The free cash flow hypothesis asserts that the value of the firm should increase if over-investing managers pay out more of the cash flows as dividends. Positive abnormal returns in case of dividend increases and negative abnormal returns in case of dividend reductions are also expected according to the cash flow signaling hypothesis, however. Hence dividend pay-out ratio is used as a proxy for future expected performance of firms. The information on dividend payout ratios for different companies is gathered from the PROWESS (CMIE) data base.

BSE 200 companies representing different size across industries are to be considered for the study as more than that would have been difficult to manage for a clinical exploration. The companies chosen are listed in BSE irrespective of their boundaries confined to India or abroad. The study made an attempt to focus on five years data from 2006-2010 but due to non-availability of data of 5 years for all the companies finally the study could include only 163 companies from the BSE 200 list.

6.2. **Correlation between Governance and Performance**

Two types of cross sectional analysis were carried out. First correlation analysis was done between the CG score and firm level performance. For establishing the relationship, an index for Governance Score has been
developed following the practices of Institute of Company Secretaries of India (ICSI) in developing governance scores for corporate India. Governance score would be the sum of the discrete figures assigned to companies on the basis of some governance factor, which are found out from ICSI’s prevailing practice. ICSI scores attempt to assess the effectiveness of individual company’s governance practices as a system of interaction among a company’s management, board, shareholders and other stakeholders aimed at building company value and ensuring fair distribution of its earnings. To assess which categories and factors influence good/bad performance of firm, regression analysis is carried out with different performance measures as dependent and individual governance mechanism as independent factors.

In developing the Corporate Governance Score (CGS) first of all four sub-indices were developed for five important governance facets, i.e., Board Process and Structure (BPS), Ownership Structure (OS) and the functioning of audit, remuneration and grievance committees, those are often highlighted in prior research studies. These five sub-indices have been summed up to develop the CGS. The index developed will be used as a proxy for corporate governance practices in various quantitative analyses. A higher score represents good governance while a small number indicates poor governance in a firm.

The descriptive statistics for sample independent variables reveal a mean value of 11.3 of Board process and structure. It is also observed that, most of the
firms in our sample have separate leadership structure (i.e. chairman and nonexecutive), having very large board structure consisting of maximum independent directors who are present more than 90% of times boards meet. Similarly, average samples firms have a balanced ownership structure between institutional and promoters. Likewise, mean value of 13.137 of audit committee implies that sample firms have large audit committee consisting of maximum independent members. Further, audit committee frequently meet with attendance more than 90%. Mean score of 10.37 for remuneration committee indicates that the committee consists of maximum members most of whom are independent. Moreover the committee meets frequently with attendance more that average. The average score of 8.3 indicates that the grievance committee is not so effective as a governance measure in terms resolving cases, frequency of meeting and independence. The sample firms largely vary on each parameter of their performance as indicated by the mean and standard deviation figures reported.

The correlation matrix has been presented to describe the linear relationship between five governance facets and six performance variables. It is observed that Board shares a negative significant relationship with PB Ratio, Return on Equity, Sales Growth but a positive significant relationship with EBITA margin. But ownership and remuneration committee has only relationship with return on equity and EBITA margin respectively. Further, there is no relationship between the governance variable, Grievance Committee and performance variables. Finally, audit committee shares significant positive
relationship with three performance variables only such as EBITA margin, Return on Equity and DIV on PAT.

6.3. Impact of Governance on Performance

Subsequent to correlation analysis, a regression analysis of the impact of governance index score (an index constructed based on five governance facets) on six performance measure variables were done independently. The model is estimated using Ordinary Least Square method. It is observed from the result that governance does not have any significant impact on PB Ratio, EBITA margin, payout ratio and growth of the sales of the firms. However the results reveal that good governance contributes significantly to Return on Equity. It is observed that the Ordinary Least Square model deployed in the aforementioned bivariate regression analysis fails to carry significant predictive power and assumes that the entire firms are homogenous even through the presence of heterogeneity is in cross sectional series.

Thus for the appropriate model to be applied for the Bivariate analysis, the study has conducted Hausman Test with the null hypothesis that the random effect is applicable and alternative hypothesis is the application of fixed effect model. The results do not support the rejection of the null hypothesis that the application of random effect model for our study of the impact of the governance index on six performance variables of the firm, except for the study between return on equity and governance index.
Summary & Conclusion

It is observed from the panel regression analysis that governance factors don’t contribute to the firms’ PB ratio signifying that good governance is not of a great help in market value addition of a firm. Same results are also obtained for EBITA margin and sales growth of the firms. In case of ROE, it is evident that the slope coefficient between return on equity and governance index is negative and statistically significant at 10% level of confidence. That better governance contributes negatively to return on equity. It is substantiated by the model applied with R-square value of 68% which holds significant explanatory power. Finally the prevalence of cash flow hypothesis or dividend signaling hypothesis could not be established in the study.

6.4. Impact of Individual Governance Components on Firm Performance

In the last section, the study investigates the relationship between various facets of corporate governance and six different performance variables independently. In order to draw a reliable conclusion, a multivariate regression framework is used. The analysis of the impact of the five different constituents of corporate governance (Board Process and Structure, Ownership Structure, Audit committee, Remuneration Committee and Grievance Committee) on Price to Book value ratio exhibits that the Price to Book ratio is impacted by three governance facets like Board process and Structure, Ownership and Governance committee. A negative correlation between firm value and the size of a firm’s board of directors supports the findings of many of the previous studies.
Summary & Conclusion

A subsequent analysis of the impact of five governance variables on firms’ EBITA margin reveals that both Board structure and process and Remuneration Committee share a positive and significant predictive relationship with firms’ EBITA margin while the audit committee negatively related to EBITA margin implying that more the no of audit activities, the EBITA margin will decline and vice-versa. Similarly an analysis of the impact of corporate governance variables of the Return on Equity highlights that both Audit committee and Ownership structure share an influencing relationship with ROE. As both the variables are part of the monitoring mechanism of the agency theory of governance, the significance of the coefficients indicates that stronger monitoring will improve the return on equity and slack monitoring will result in lesser return on equity.

A cursory look at the impact of individual governance facets portrays that none other than Board Process and Structure shares a significant predictive relationship with Sales growth as a measure of performance of the firms. Though the relationship is negative it is significant. It indicates that a higher growth in sales is hampered due to bigger size of the Board, more and more meetings etc. The possible reason may be the delay in decision making process that is prevalent in a larger board. In case of Dividend Payout ratio, it’s only the Audit committee that explains the dividend payout signifying that a stringent audit activities result in more dividend payout.
The above results obtained through Ordinary Least Square model in the aforementioned multivariate regression analysis may have some limitation as the model assumes that the entire firm are homogenous even through the presence of heterogeneity is in cross sectional series. Thus a further verification through a panel data analysis is thought to be appropriate for the multivariate analysis. In order to specify the panel regression model, we have applied Hausman Test with the null hypothesis that the random effect is applicable and alternative hypothesis is application of fixed effect model. The result of Hausman Test favoured the application of random effect model for the study.

The panel result reports the impact of three out of five corporate governance variables on Price to Book ratio. While the Board Process and Structure impacts Price to Book ratio negatively, ownership structure and governance committee impacts the ratio positively. PB ratio is not explained by other governance factors like audit committee and remuneration committee. Interestingly none of the governance facets has a significant influence on the EBITA margin of the firms. Another measure of performance, Return on Equity is found to be negatively affected by the Board Process and Structure and positively impacted by the ownership structure of the firms. Consistent with the OLS result, the sales growths of the firms are not influenced by any governance variable other than Board Process and Structure. The size of the Board is negatively related with sales growth. The panel data analysis also reveals that Dividend payout ratio is negatively influenced by the Board
Process and Structure and positively related with the audit committee. More the activities of the audit committee, one can expect a better dividend payout ratio. However, increase in Board size results in lesser dividend payout ratio.

6.5. **Recommendation for Future Research**

As already indicated, it would have been ideal to have had a large data set and probably from a lot more Indian Companies. The selection of corporate governance variables though consistent with several studies was primarily as a result of data limitations. In the future, we would want to take a broader look at corporate governance indicators for a thorough understanding of corporate governance matters on the Indian context. In spite of the acknowledged limitations to this study, conclusions based on the findings of the study are not compromised and that the study has to a large extent contributed to our understanding of corporate governance on the Indian Context.

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