2 LITERATURE REVIEW

2.1 Overview of the chapter

Corporate governance has been defined in different ways by different authors. Zingales (1998) defines corporate governance as a complex set of constraints that shape the ex post bargaining over the quasi-rents generated by a firm. Hussey (1999) defines corporate governance as the manner in which organizations are managed and the nature of accountability of the managers to the owners. From these definitions, it may be stated that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies.

In a much wider sense, Markus (2007, p. 2) defines good corporate governance as “a set of institutions, i.e. formal and informal constraints on behaviour, determining the capacities of firm stakeholders to control the decisions and the cash flows in a given corporation”, and then he argues that “the firm level corporate governance institutions, fulfils a variety of goals for the enterprise insiders, some of which are entirely decoupled from the perfunctorily assumed all-trumping financing needs of enterprises” (Markus, 2007, p.3). On the same line, for Borsch-Supan and Koke (2002, p. 295) good corporate governance is:

[. . .] the complex system of control mechanisms supposed to influence management behaviour in order to guarantee a high value of the owners’ equity in the firm, and it is an efficient system, which reduces the agency costs
resulting from the divergence of interests between the owners and the managers of the firm. A Board of Directors system is a vital factor in corporate governance. The Board functions as a bridge between insiders (such as the various managers) and outsiders (other interested parties and shareholders), and is chiefly responsible for representing shareholders in company business operations and for the supervision of management, thereby maximizing profits for all shareholders (Chen, Chen, Wu, 2011).

This chapter reviews the literature relating to corporate governance. This chapter reviews all the relevant and prominent studies on this issue.

2.2 Corporate governance and Capital Structure

Over two decades of research suggests that debt can act as a self-enforcing governance mechanism; that is, issuing debt holds managers’ feet to the fire by forcing them to generate cash to meet interest and principal obligations. Thus, debt mitigates the potential agency costs of free cash flow (Grossman and Hart, 1982; Jensen, 1986, 1993). The counter-arguments are that most firms can easily meet interest payments and firms typically rely on internal financing (Allen and Gale, 2000). Shleifer and Vishny (1997) discuss the role of debt in governance, and John and John (1993) provide an in-depth analysis of the link between capital structure and compensation.

Recent empirical work on corporate governance and capital structure focuses on the association between governance and the cost of debt. For example, Klock et al. (2005) find that increased use of antitakeover measures is associated with lower costs of debt financing. Similarly, Cremers et al. (2004)
report that the presence of institutional block holders is associated with lower yields, particularly in the presence of multiple antitakeover measures.

Bryan et al. (2006) emphasize the link between compensation and the agency costs of debt. The authors note that, although contracting theory predicts that greater equity-based compensation decreases the agency problems of equity, it may exacerbate the agency problems of debt. They observe that while the agency costs of debt, which include under investment, asset substitution, and financial distress, became less likely during the 1990s, firms became more difficult to monitor, and thus the agency costs of equity rose. The authors suggest that the net effect of these changes explains why more firms used equity-based compensation in the latter 1990s, and why the proportion of options in the compensation mix increased throughout the 1990s.

With regard to institutional investor monitoring, Hartzell and Starks (2003) suggest that concentrated institutional ownership moderates executive compensation. However, others have argued that institutional investors may be subject to potential conflicts of interest when it comes to monitoring corporate management. For example, Woidtke (2002) suggests some institutions that are able to monitor are subject to conflicts of interest with other shareholders, and thus their monitoring role is potentially compromised. More recently, Davis and Kim (in press) report that, although mutual funds are no more likely to vote with management of client versus non-client firms, there is a positive relation between business ties and the propensity of mutual funds to vote in favour of management proposals.

Other papers focus on the importance of block ownership to effective corporate governance. Bethel et al. (1998) report that active block holder's lead to
enhanced shareholder value. Holderness (2003), in a survey of the literature, concludes that while block holders have incentives to monitor management, they might also consume corporate resources. Studies of block ownership often use hand-collected data from proxy statements. Others rely on data from CDA Spectrum (now Thomson Financial) or Compact Disclosure. However, Anderson and Lee (1997a,b) and Bhagat et al. (2004) identify significant problems with the CDA/Spectrum data and question its use.

Abor and Biekpe (2007) examine the relationship between corporate governance and capital structure decisions of Ghanaian Small and Medium Enterprises by using multivariate regression analysis. The results provide evidence about negative relationship between board size and leverage ratios and SMEs with larger boards generally have low level of gearing. On the other hand, Wen (2002) finds positive relationship between board size and capital structure. He argues that large boards follow a policy of higher levels of gearing to enhance firm value especially when these are entrenched due to greater monitoring by regulatory authorities. Since mixed views are present with regard to this aspect, this research attempts to identify the relationship between good corporate governance and its effect on capital structure in terms of board size in select companies from India.

A great deal of empirical research to analyze the influence of corporate governance on capital structure has been carried out in developed countries (see, e.g. Anderson et al., 2004; Berger et al., 1997; Fosberg, 2004; Friend and Lang, 1988; Mehran, 1992); whereas, little is known about the developing countries that have different institutional structures (see, e.g. Abor, 2007; Bokpin and Arko, 2009; Kyereboah-Coleman and Biekpe, 2006; Wen et al.,
2002). In particular, empirical research to estimate the impact of some corporate governance attributes such as board size, outside directors, ownership concentration, managerial ownership, director remuneration, and CEO duality etc., on capital choices of firms in India is very much limited. Thus, a diminutive research in this area has evoked the need for this study.

2.3 Corporate governance and Firm Characteristics

2.3.1 Corporate governance and Board Size

An effective board is essential to the success of a company. The board being the highest decision making body in a company has the responsibility to provide superior strategic guidance to ensure the firm’s growth and maximize the return to investors. Moreover, board is charged with monitoring and disciplining the senior management. According to Adams and Mehran (2003) a bigger board can effectively monitor the actions of management and provides better expertise. Conversely, Lipton and Lorsch (1992) asserts that large boards are less effective compared to small boards because some directors may free-ride on the efforts of others. Existing literature relevant to board size and capital structure yields mixed findings. Berger et al. (1997) found a significant and negative correlation between board size and leverage. Wiwattanakantang (1999) found that board size is negatively related with leverage but the relationship is statistically insignificant. Anderson et al. (2004) found a negative relationship between board size and the cost of debt financing. Moreover, they showed that an additional board member is associated with about a 10 basis point lower cost of debt financing. Thus, this finding suggests that large boards adopt high debt policy to raise the value of
the firm. Abor (2007) and Bokpin and Arko (2009) reported a significant positive relationship between board size and capital structure for Ghanaian firms.

Kyereboah-Coleman and Biekpe (2006) have shown a significant and positive association between board size and the total debt ratio and the short-term debt ratio. Wen et al. (2002) found a positive relationship between board size and leverage but the relationship is statistically insignificant.

Board Size is the number of directors serving on a Board. Identifying an appropriate and optimal Board size in a corporate has been a matter of debate in numerous studies (Lipton and Lorsch, 1992; Jensen 1993; Yermack, 1996; Dalton et al., 1999; Hermelin and Weisbach, 2003). While some researchers supported smaller Boards (e.g., Lipton and Lorsch, 1992; Jensen 1993; Yermack, 1996), others have suggested larger Boards are better for improving firm performance (Pfeffer, 1972; Klein, 1998; Adams and Mehran, 2003; Anderson and Reeb, 2003; Coles, et al., 2008).

Lipton and Lorsch (1992) favoured smaller Boards, suggesting that larger Boards might face problems of social loafing and free riding, suggesting an optimal Board size between seven and nine directors. As Board increases in size, free riding increases and efficiency of the Board is reduced. This was confirmed by Jensen (1993) who favoured small Boards on the ground that it leads to better decision-making due to greater coordination and lesser communication problems. Yermack (1996) and Eisenberg et al., (1998) have also provided evidence that smaller Boards are associated with higher firm value. Yermack (1996) reveals that a large Board size is negatively associated with firm performance and firms with small Boards use their assets more effectively and achieve higher profits compared to firms with large Boards. The
larger Boards have to face problems of communication and cohesiveness and may result in conflicts (O'Reilly et al., 1989).

However, this view has been challenged by other researchers like Dalton et al., (1999) and Coles et al., (2008) who argued that larger Boards may improve firm performance. For example, Dalton et al., (1999) suggested that Board size is significantly associated with both firm performance measures i.e., accounting and market-based. They argued that a large Board size can contribute to external resources linkage. Haleblian and Finkelstein (1993) argued that the main advantage of a large Board is that a large group has more problem-solving capabilities. Klein (1998) supported this view arguing that CEO’s need for advice increases with the complexity and size of organisation. The diversified firms operating in multiple segments might require greater advice and discussion (Hermalin and Weisbach, 1988; Yermack, 1996) and therefore, larger Boards are required for these firms.

From an agency theory perspective, larger Boards allow for effective monitoring by reducing the dominating role of CEO within the Board and protect shareholders interests (Singh and Harianto, 1989). According to Hermalin and Weisbach (1998), Board effectiveness is a function of its independence. The independence of a Board depends on the negotiations between the Board and the CEO. A larger Board improved the bargaining position of the Board vis-à-vis the CEO and thus, make the Board more effective in monitoring the management. Further, larger Board also makes it easy to create committees to delegate specialized responsibilities.

Resource dependency theory suggests that Boards are chosen to maximise the provision of important resources to the firm (Pfeffer, 1972; Pfeffer and
Salancik, 1978; Klein, 1998; Hillman and Dalziel, 2003). Klein (1998), for instance, suggests that advisory needs of the CEO also increase with the firm’s dependence on the environment for resources. So, increasing Board size links the organization to its external environment and secures critical resources. In response to resource dependencies and regulatory pressures, organizations create large Boards to encompass directors from different backgrounds (Pfeffer, 1972; Pearce & Zahra, 1992).

In short, while the smaller Boards allow domination of Board by CEO resulting in agency costs, larger Boards benefit firms by providing effective oversight of management, making available necessary resources and allowing for representation of different stakeholders in the firm. These benefits provided by large Boards help in firm performance. It is very interesting to investigate whether or not Board size is significantly correlated to firm performance in Indian firms.

2.3.2 Corporate governance and Board Composition

The second variable of interest is Board composition. By Board composition, it means the presence of executive and non-executive directors on the Board. The important issue here is the presence of non-executive/ outside directors on the Board. From the perspective of solving Berle and Means (1932) agency problem between management and shareholders; appointing outsiders seems to be the natural solution. John and Senbet (1998) suggested that a Board is more independent if it has more non-executive directors. A number of empirical studies have been conducted in developed countries on whether there is any link between independent directors and corporate performance. Some researchers have looked for a direct evidence of the link between Board
composition in terms of independence and corporate performance. Independent directors are invited onto the Board in order to oversee management on behalf of shareholders (Baysinger and Butler, 1985).

The studies by Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) have shown that market reward firms for appointing outside directors. Baysinger and Butler (1985) examined the relationship between Board composition and financial performance and suggested that firms with more independent Boards have superior performance. Rosenstein and Wyatt (1990) also suggested that higher proportion of independent directors is positively associated with excess returns. Similarly, Mak and Kusnadi (2005) revealed that a higher fraction of independent directors on the Board is linked to greater firm value. In their study, Brickley et al., (1994) tested the relationship between proportion of outside directors and stock-market reactions to poison pill adoptions and found positive relationship between the two.

However, Yermack (1996) showed that proportion of outside directors does not significantly affect firm performance. Similarly, Forsberg (1989) also did not find any relationship between the proportion of outside directors and various firm performance measures. Consistent with this notion were Hermalin and Weisbach (1991) and Bhagat and Black (2002) who also failed to find any significant relationship between Board composition and firm performance. Agrawal and Knoeber (1996) opined that Boards expanded for political reasons often result in too many outsiders on the Board, which does not help in the improvement of performance.
From an agency theory perspective, a supervisory Board should be dominated by independent non-executive members in order to generate effective monitoring of executives. However, stewardship theory says that Board composition should be dominated by inside members in order to make effective decisions, since insiders are better informed about the firm than outside directors. The contradictory predictions from theory are mirrored in the available evidence. Some studies found evidence supporting agency theory and some others have revealed evidence in support of stewardship theory. Thus, no convincing conclusion can be drawn from prior studies on the impact of Board composition and Board leadership on firm performance.

Abor and Biekpe (2007) provide evidence about the presence of positive relationship among gearing levels and CEO duality, board skills and board composition. Ghanaian SMEs provides evidence that more outside directors and a diversified set of skills at board generally have higher level of gearing. On the other hand researchers like Wen (2002) provides evidence about the existence of significantly negative relationship between gearing level and representation of non-executive directors on the board. The possible reason is that non-executive directors monitor the managers more efficiently and effectively so managers are forced to seek lower gearing levels for achieving superior results. Similarly companies with higher representation of non-executive directors are bound to follow low financial leverage with a high market value of equity.

2.3.3 Corporate governance and Board Activity Intensity

To explain the role of Board activity in Corporate governance, the study develops arguments linking Board activity to a wide array of governance
variables. According to Vafeas (1999), the Board activity intensity is an important value-relevant Board attribute. Some contend that Board meetings are beneficial to shareholders; while others have argued that these meetings are not necessarily useful. The association between Board meeting frequency and firm performance is not clearly established. First, there are many costs associated with Board meetings, including managerial time, travel expenses and directors’ meeting fees. On the other hand, there are also benefits including more time for directors to confer, set strategy and monitor management. If a firm is reasonably efficient in setting the frequency of its Board meetings, depending on its environment, it will attain economies in agency costs.

The Board processes have a significant impact on firm performance; and meetings are necessary for the effectiveness of Board tasks (Zahra and Pearce, 1989). When Board of directors meet frequently, they are more likely to discuss the concerned issues and monitor the management more effectively, thereby performing their duties with better coordination and in harmony with shareholders’ interests (Lipton and Lorsch, 1992). Consistent with this notion, Conger et al., (1998) suggested that Board meeting time is an important resource for improving the Board effectiveness and thus, better decision-making. But there are also costs attached with Board meetings- managerial time, travel expense, directors’ fees and other resources (Vafeas, 1999). Lipton & Lorsch (1992) and Jensen (1993) pointed out that the limited time available for meetings might not be sufficient for substantial dialogue among directors. It is contended that routine tasks absorb much of the meetings and this limits opportunities for NEDs to exercise meaningful control over management and
therefore, Boards should be relatively inactive and are required to become active only in the times of trouble (Jensen 1993). The relationship between Board activity and firm performance is a valid research question to be examined empirically.

Bhagat and Bolton (2008) found CEO-Chair separation to be significantly positively correlated with firm’s operating performance; on the other hand, Boyd (1995) found that CEO *duality* improves firm performance. Rechner and Dalton (1991) also supported separation of CEO and chair positions; they found in their study of 141 corporations that the firms opting for independent leadership have outperformed the firms relying on CEO *duality*. Some authors found no significant difference between the firms with CEO duality and those without (Daily and Dalton 1997; Dalton et al., 1998). In fact, Daily and Dalton (1997) suggested that separation of CEO and Board chair positions results in misdirected effort.

2.3.4 Corporate governance and Non-executive directors and capital structure:

Abor and Biekpe (2007) provide evidence about the presence of positive relationship among gearing levels and CEO duality, board skills and board composition. Ghanaian SMEs provides evidence that more outside directors and a diversified set of skills at board generally have higher level of gearing. On the other hand researchers like Wen (2002) provides evidence about the existence of significantly negative relationship between gearing level and representation of non-executive directors on the board. The possible reason is that non-executive directors monitor the managers more efficiently and effectively so managers are forced to seek lower gearing levels for achieving
superior results. Similarly companies with higher representation of non-executive directors are bound to follow low financial leverage with a high market value of equity.

### 2.3.5 Corporate governance and Ownership concentration

The ownership of block-holders may help to mitigate the agency problems between managers and shareholders. In general, block-holders have more ability than dispersed shareholders to influence the management’s decisions. For instance, block-holders may force the management to take those actions that maximize the shareholder’s wealth. They may demand higher debt levels due to low cost compared to new equity issue. Apart from tax shields considerations, block-holders may force management to use more debt because it reduces the management’s discretionary control over the firm’s cash flow, and stop them to engage resources in inefficient activities. Although the use of debt may also increase the bankruptcy risk but investors who owned a well-diversified portfolio of investments can manage the risk. Friend and Lang (1988) argued that firms with major shareholders tend to have higher debt ratio than those with no major shareholders. These explanations suggest a positive association between block-holders share ownership and leverage. Brailsford et al. (2002) have shown a statistically significant and positive relationship between shares owned by external block-holders and leverage. Fosberg (2004) found that the amount of debt in a firm’s capital structure is directly related to the proportion of shares held by the block-holders but inversely related to the number of block-holders a firm has. Mehran (1992) reported a positive and statistically significant relationship between ownership by largest individual
investors and short-term debt ratio; however, the relationship is insignificant with long-term debt ratio.

The empirical results of this study provide support to corporate managers in establishing an optimal capital structure, and to regulatory authorities for enacting laws and developing institutional support to make corporate governance mechanisms work more effectively in the country.

A number of studies on the capital structure determination reported a positive relationship between market-to-book ratio and leverage ratio including that by Dalbor and Upneja (2002), Tang and Jang, (2007) and Zou and Xiao, (2006) in promoting the growth of a company.

The trade-off theory suggests a positive relationship between the share of fixed assets and debt ratio, since fixed assets serve as collateral for debt financing. Thornhill et al (2004) cements this view by indicating that firm will obtain debt more easily as collateral value of fixed assets rise.

According to the trade-off theory, there should be a positive relationship between effective tax rates and debt ratio (DeAngelo and Masulis, 1980; Haugen and Senbet, 1986). This is because deduction of financial expenses from taxable income decreases effective cost of debt. Thus, advantage of debt financing increases along with increases in tax rates (Brigham and Houston, 2004). A positive relationship should, therefore, be expected between effective tax rates and debt level (Qian et al., 2007).

### 2.3.6 Corporate governance and Institutional Ownership

Rise of institutional investors was one of the main reasons why Corporate governance became a burning topic in 1990s. The role that institutional
investors can play in the Corporate governance system of a firm is a controversial question. While some believe that institutional investors must interfere in the Corporate governance system of a company, others believe that these investors have other investment objectives to follow.

Those who believe that institutional investors need not play a role in the Corporate governance system of a firm argue that investment objectives and compensation system in the institutional investing companies often discourage their active participation in the Corporate governance system of the companies. Wharton et al., (1991) argued that institutional investors need not take active interest in the Corporate governance of a company because they have their primary fiduciary responsibility to their own investors and beneficiaries which can lead to a conflict of interest with their acting as owners. Similarly, Drucker (1976) once commented that “it is their job to invest the beneficiaries’ money in the most profitable investment. They have no business trying to manage. If they do not like a company or its management, their duty is to sell the stock”.

Many researchers like Admati et al., (1994), Black (1990), Coffee (1991) and Monks (1995) have argued that absence of appropriate incentives and free rider problems hinder institutional activism efforts. The free rider problem comes because even when one institutional investor interferes, the other investors get the benefits. Hence, the costs associated with active monitoring are borne by only one investor and this discourages active intervention.

Del Guercio and Hawkins (1997), John and Klein (1994), Karpoff et al., (1996) have observed that institutional activism has negligible impact on firm performance. Marsh (1990) has argued that the short-term performance measurement work against the active monitoring by the institutional investors.
The performance of fund managers is evaluated over a shorter time period. Hence, they act under tremendous pressure to beat some index. So when they found a case of bad governance, they found it economical to sell the stock rather than interfere in the functioning of the company and incur monitoring costs. Mohanty (1998) has also found that in India, the short-term performance measurements of the fund managers force them to become very short-term oriented.

Another reason often cited by researchers is that the institutional investors are not competent enough to interfere in the activities of the companies. Cordtz (1993) has argued that the institutional investors lack the expertise and ability to serve as effective monitors. Similarly, Charles Wohlstetter, former CEO of Contel, wrote in a paper titled, "The fight for good governance" published in the Harvard Business Review in January-February, 1993 that "in sum, we have a group of people with increasing control of the Fortune 500 who have no proven skills in management, no experience in selecting directors, no believable judgment in how much should be spent for research or marketing- in fact, no experience except that which they have accumulated controlling other people’s money".

There are others, however, who strongly believe that if the Corporate governance system in the companies has to succeed, then the institutional investors must play an active role in the entire process. Shleifer and Vishny (1986) observed that institutional investors by virtue of their large stockholdings would have greater incentives to monitor corporate performance since they have greater benefits of monitoring. Most of the reports on Corporate governance have emphasized the role that the institutional investors have to play in the
entire system. For example, Cadbury committee (1992) stated that “because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders’ Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code”. The working group on Corporate governance of Harvard Business Review has, similarly, concluded "the institutional investors of public companies should see themselves as owners and not as investors".

In India, the CII report and Kumar Mangalam Birla committee on Corporate governance has also brought out the importance of the role that the institutional investors can play in the Corporate governance of a company. These reports raise one interesting question that must be answered before one can comment on the role that the institutional investors should play in the Corporate governance system of a company. Institutional investors are answerable to their investors the way the companies (in which they have invested) are answerable to their shareholders. And the shareholders do invest their funds with the institutional investors expecting higher returns. The primary responsibility of the institutional investors is therefore, to invest the money of the investors in companies, which are expected to generate the maximum possible return rather than in companies with good Corporate governance records. Most of the Corporate governance reports ignore this aspect when they expect institutional investors to play the role of an active investor. In this study, an attempt has been made to understand the role of institutional investors in the Corporate governance structure of India.
2.3.7 Corporate Governance and Corporate Dividend Policy

The association between corporate governance and dividend policies/pay-outs have been widely investigated by several researchers in this domain, presenting varied outcomes. While some observed positive association between both the entities, where corporate governance is highly influenced with large dividend pay-outs (Michaely and Roberts, 2006; Sawicki 2005), the others contradict this observation (Nielsen, 2006; Jiraporn and Ning 2006).

It is believed that the dividend pay-outs diminish the agency conflicts by minimizing the free cash flow (DeAngelo, and Stulz, 2006). It can also avoid the expropriation of minority stakeholders by the others, depending on the laws and rules involved in the corporate governance. According to Mitton (2004), the firm-level corporate governance and dividend pay-outs have a strong association in the regions where the protection of shareholders is given paramount importance. The countries aligning with such protection precautions believe in offering high levels of protection to their investors through legal measurements. Such measures enhance the effectiveness of corporate governance at firm levels.

2.3.8 Corporate governance and Firm Performance

The research on the relationship between Corporate governance and firm performance has risen in prominence in the early eighties and after more than two decades, in the present times too, it is still a topic of hot debate. Some of the prominent studies conducted in various countries other than India which have done empirical investigation on the relationship between Corporate
governance and firm performance have been discussed year-wise in the sub-section 2.4.1.

In the early eighties, Baysinger and Butler (1985) examined the effect of changes in Board composition on performance. More specifically, they examined performance differences across corporations as a function of differences in Board independence and changes in independence occurring between 1970 and 1980. The measure of financial performance selected for use in the empirical analysis is relative financial performance which is calculated by dividing the firm's return on equity by the average return on equity for all the firms in its primary industry, including those not in the sample. In order to examine dynamic processes regarding the effect of the relation between Board composition and performance, the sample of 266 firms was divided into four categories based on above average and below average relative financial performance in the early and late 1970s. The findings of the study suggested that firms with higher proportions of independent directors at the beginning of the decade ended up with superior performance records, on average, later in the period.

The paper by Dalton and Kesner (1987) provided an empirical assessment comparing Board composition and CEO duality between the industrial firms of Japan, United Kingdom and United States. The companies relied on for this study is comprised of three randomly chosen samples of 50 large Japanese, United Kingdom and United States industrial corporations for a total sample of 150. The data was collected from Moody's International Manual (1986) and Standard and Poor's Register of Corporations, Directors & Executives (1986). Results indicated marked differences in these Corporate governance
dimensions. In Japan, it is evidently unusual for the same individual to serve as CEO and chairperson of the Board. This is much more frequent in United Kingdom and is commonplace in United States. Further, the percentage of outside Board members in Japan is less than would be typically found in either United Kingdom or United States.

Kosnik (1987); based on predictions from agency theory and a theory of managerial hegemony, this study compared the Board structure of 53 companies that privately repurchased stock at a premium above the market place i.e., paid greenmail and 57 companies that resisted greenmail. The decision to pay greenmail was used as a proxy for the Board's ineffectiveness, which is defined as the inability of the Board's outside directors to prevent management from making decisions such as paying greenmail-that are in conflict with stockholders' interests. Boards that effectively resisted greenmail were found to have more outside directors, more directors with executive experience, and more directors who represented inter-organizational transactions than Boards of companies that paid greenmail.

Hermalin and Weisbach (1988) identified the factors that lead to changes among corporate directors. They hypothesized in their study that CEO succession process and firm performance affects Board composition. Their findings turned out to be consistent with both the hypotheses. When their CEO nears retirement, firms tend to add inside directors who may be possible candidates to be the next CEO. Just after a CEO change, inside directors with short tenures appeared more likely to leave the Board. The authors also found that inside directors are more likely to leave the Board and outside directors are
more likely to join after a firm performs poorly and when a firm leaves a product market.

Schellenger et al., (1989) examined the impact of Board composition on risk-adjusted market return measure of firm's performance in the year 1986. Apart from risk-adjusted market return, the study has also used ROA, ROE and shareholder's annualized total return on investment as the measures of firm's performance. Using a sample of U.S firms, a direct relationship has been found between outside director representation and corporate financial performance.

Rechner and Dalton (1991) examined the differential financial implications of these choices for 141 corporations over a 6-year time period i.e., 1978-1983. The measures used were ROI, ROE and profit margin for performance and multivariate analysis of variance was relied on for analysis. The objective of this research was to provide multiple-year comparisons of financial performance between firms with CEO duality versus those with independent positions. Results indicated significant differences in performance between the two groups along a number of performance measures; more specifically, firms opting for independent leadership consistently outperformed those relying upon CEO duality.

Barnhart et al., (1994) & Barnhart and Rosenstein (1998) investigated the effect of Board composition on overall corporate performance while controlling for managerial ownership and other key variables. They recognized that both managerial ownership and Board composition may be endogenous to performance. They measured performance using the market value to book value ratio of common stock equity. Second, recognizing that overall estimates from the instrumental variable approach depend greatly on the choice of
instruments, they performed sensitivity analysis by using a variety of instruments to proxy for Board composition and managerial ownership. Both their ordinary least squares and instrumental variable estimates indicated significant curvilinear relationship between Board composition and performance.

Bathala and Rao (1995) examined the interrelation between Board composition and variables that capture various agency and financial dimensions of the firm. The agency literature suggested that outside directors on the Board provide important monitoring functions in an attempt to resolve, or at least mitigate, agency conflicts between management and shareholders. This study documented an inverse relationship between the proportion of external members on the Board and managerial stock ownership, dividend pay-out and debt leverage. This is consistent with the hypothesis that individual firms choose an optimal Board composition depending upon alternative mechanisms employed by the firm to control agency conflicts. Board composition is also found to be systematically related to a number of other variables including institutional holdings, growth, volatility, and CEO tenure.

Agrawal and Knoeber (1996) examined the use of seven mechanisms to control agency problems between managers and shareholders. These mechanisms include shareholdings of insiders, institutions, and large blockholders; use of outside directors; debt policy; the managerial labour market; and the market for corporate control. They employed a sample of nearly 383 large U.S. firms for the year 1987 and found evidence of interdependence among the control mechanisms. Next, they examined the empirical relation between the above mechanisms and firm performance as measured by Tobin's
Greater insider ownership was positively related to performance, while more outsiders on the Board, more debt financing, and greater corporate control activity were negatively related to performance. It was found that more outsiders on the Board of directors have negative impact on firm performance. The possible reasons that they have given are such that Boards are expanded for political reasons, perhaps to include politicians, environmental activists, or consumer representatives and that these additional outside directors either reduce firm performance or proxy for the underlying political constraints that led to their receiving Board seats.

Balinga et al., (1996) while examining the relationship between duality and firm performance considered the announcement effects of changes in duality status, accounting measures of operating performance for firms that have changed their duality structure and long-term measures of performance for firms that have had a consistent history of a duality structure. The results suggested that the market is indifferent to changes in a firm's duality status. They found no evidence of significant announcement effects associated with changes in a firm's duality status. Finally, there is only weak evidence that duality status affects long-term performance, after controlling for other factors that might impact that performance.

Brickley et al., (1997) provided discussion of both costs and benefits of separate titles. They have presented empirical evidence on this topic. First, they found that, while about 14% of the firms separate the titles, most of these firms are simply transitioning to new CEOs. For most of these firms, good-performing CEOs are eventually granted both titles. Thus, the frequently-cited statistics on the frequency of separate titles overstate the incidence of firms
with fundamentally different leadership structures. Rather, they largely reflected cross-sectional differences in the timing of CEO successions. Second, the data suggested that the potential costs of separating the titles are important in determining the leadership structures in U.S. firms. Third, the evidence suggested that some firms used the title of chairman as an incentive device for new CEOs. Thus, requiring a separation of the titles would force some firms to alter their basic incentive systems for new CEOs. Fourth, the event-study evidence, as well as evidence from accounting returns, is inconsistent with the conclusion that firms with separate titles outperform firms with combined titles.

Klein (1998) demonstrated a linkage between firm performance and Board composition by examining the committee structure of Boards and the directors’ roles within these committees and found little association between firm performance and overall Board composition. However, by going into the inner workings of the Board via Board committee composition, he did not find significant ties between firm performance and how Boards are structured. First, a positive relation is found between the percentage of inside directors on finance and investment committees and accounting and stock market performance measures. Next, firms significantly increase inside director representation on these two committees experience significantly higher contemporaneous stock returns and return on investments than firms decreasing the percentage of inside directors on these committees. These findings were consistent with Fama and Jensen (1983) assertion that inside directors provide valuable information to Boards about the firms’ long-term investment decisions.
Vafeas (1999) has conducted an analysis for 307 firms over the 1990-1994 time-period and found that Board meeting frequency is related to Corporate governance and ownership characteristics in a manner that is consistent with contracting and agency theory. The annual number of Board meetings is inversely related to firm value. This result was driven by the increases in Board activity following share price declines. Further, it was found that operating performance improves following years of abnormal Board activity. These improvements are most pronounced for firms with poor prior performance and firms not engaged in corporate control transactions. Overall, the results suggested that Board activity is an important dimension of Board operations.

Prevost et al., (2002) model the composition of New Zealand Boards of directors as a function of alternative Corporate governance mechanisms, other control variables and legislation designed to improve corporate monitoring. Data for this study has been obtained for a sample of 607 firms listed on the New Zealand Stock Exchange for the years 1991 through 1997. Data on Board composition and insider ownership was extracted from two sources: questionnaire surveys sent to listed companies and from company annual reports. They found evidence that Board composition and firm performance jointly impact each other in a positive manner.

Further, the proportion of outsiders on the Board is positively related to Board size and is negatively related to future growth, nonlinearly related to inside ownership and is not related to debt and ownership concentration. Firm performance is inversely related to firm size, positively impacted by future growth and appears to be non-linearly related to insider ownership. Passage of the new Companies Act in 1994 is associated with increased representation of
outside Board members. However, this increase is not associated with enhanced firm performance which may be a consequence of increased liability placed on directors.

Bauer et al., (2004) analysed whether good Corporate governance leads to higher common stock returns and enhances firm value in Europe. The study used Deminor Corporate governance Ratings for companies included in the FTSE Eurotop 300. Following the approach of Gompers et al. (2003), portfolios were built consisting of well-governed and poorly governed companies and their performances are compared. The results showed a positive relationship between these variables and Corporate governance. This relationship weakens substantially after adjusting for country differences. Finally, the relationship between Corporate governance and firm performance is analyzed, as approximated by net profit margin and return on equity. A negative relationship is found between governance standards and these earnings-based performance ratios.

Hovey (2003) investigated the relationship between firm performance and Corporate governance in China. Firm performance is measured by Tobin’s q, while Corporate governance is determined based on ownership structure and concentration. He reported results of an empirical study of 97 randomly selected firms listed on Shanghai and Shenzhen stock markets over the period 1997–1999. The paper reported a series of regressions that account for different specifications of firm valuation and ownership characteristics. The results indicated that ownership concentration has little explanatory power but ownership structure does matter. Legal person’s shareholdings are positively related to firm valuation.
Judge et al., (2003) tested hypotheses about the Board structure and firm performance relationship within Russia using survey data. Despite a relatively small sample size, predictions from both theoretical perspectives were supported. Specifically, they found negative relationship between CEO duality and firm performance. This finding is noteworthy given the 1996 Russian Federal law which prohibits the CEO from also serving as Board chair. They also found that the more vigorously the firm pursues a retrenchment strategy, the more negative the relationship between proportion of inside directors and firm performance. Overall, the findings suggested that effective Corporate governance may be essential to firm performance in Russia.

Kiel and Nicholson (2003) examined the relationship between Board demographics and corporate performance in 348 of Australia’s largest publicly listed companies and described the attributes of these firms and their Boards. Two financial measures of firm performance, namely Tobin’s q and ROA have been used. They found that, after controlling for firm size, Board size is positively correlated with firm value. They also found positive relationship between proportion of inside directors and market-based measure of firm performance.

The study by Beiner et al., (2004) addressed the question whether good Corporate governance has a positive impact on the valuation of listed companies in Switzerland. They worked with a sample of 109 firms quoted at Swiss Stock Exchange. They used a broad Corporate governance index and five additional control mechanisms: stock ownership by officers and directors, outside block-holdings, leverage, Board size and the fraction of outside directors on the Board. Their results using a system of simultaneous equations
showed positive relationship between firm-level Corporate governance and Tobin’s $q$. Their analysis confirmed that causation runs from Corporate governance to firm value, but they also found evidence of reverse causality, with higher valued firms adopting better Corporate governance practices.

Drobetz et al., (2004) investigated whether differences in the quality of firm-level Corporate governance help in explaining firm performance in a cross-section of companies within a single jurisdiction. Constructing a broad Corporate governance rating (CGR) for German public firms based on the responses to objective survey questions, they documented positive relationship between governance practices and firm valuation. Two different measures i.e., Tobin’s $q$ and market-to-book ratio were used for firm performance. Evidence was provided that expected stock returns are negatively correlated with firm-level Corporate governance, if dividend yields were used as proxies for the cost of capital. An investment strategy that bought high-CGR firms and shorted low-CGR firms earned abnormal returns of around 12% on an annual basis during the sample period.

O’Connell and Cramer (2010) explored the association between firm performance and both Board size and Board composition for 44 companies quoted at Irish Stock Market. They also investigated the impact of firm size on the relationship between firm performance and Board characteristics. The performance measures used in the study are RET (one-year raw stock market return), ROA (profit before interest and tax over total assets) and FINANCIAL Q (sum of market capitalization plus long and short-term debt over the book value of total assets). They found evidence that Board size exhibits a significant negative association with firm performance and the relationship between Board
size and firm performance is significantly less negative for smaller firms. Further, a positive and significant association between firm performance and the percentage of non-executives on the Board is apparent. While the latter finding is entirely consistent with a priori theoretical predictions, studies in a number of other countries generally fail to report any significant association between Board composition and firm performance and potential reasons for this contrast are considered. The major limitation of this study was that the results were based on the analysis of one year sample period.

Yammeesri and Herath (2010) examined the influence of corporate Board structure on corporate value. The data were collected on a sample of 245 Thai non-financial listed companies and were obtained from CompuStat for the period 2003 to 2004. Performance measures include Tobin’s q and governance parameters include independent director, grey director, inside director and Board size, CEO duality. Further, committee composition variables used in the study were audit, remuneration and nomination committees.

The results of their study showed that neither independent directors nor grey directors are the significant determinants of improving firm value. Regarding the influence of inside directors on firm performance, the study found that a larger proportion of inside directors on the Board lead to greater firm value. The results suggested that inside directors can improve firm performance by providing valuable information to the CEO and other directors, obtained from their experience and knowledge and being involved with daily business of a firm. Most Thai firms are family businesses and most of inside directors are family members so they will do their best to maximize firm value. It was found that Board size has no significant relation to firm performance. It was also
revealed that CEO *duality* can be confirmed as a poor internal control since it was found that duality has a negative correlation to firm value. The study found a curvilinear correlation between inside directors and Tobin’s *q*.

Valenti et al., (2011) have investigated the effects of prior firm performance on Board composition and governance structure for a data-set of 90 companies listed on National Association of Securities Dealers Automated Quotations (NASDAQ). They followed traditional approach in using both accounting measures; Return on Assets (ROA) and Return on Equity (ROE) and market measures (return to shareholders and P/E Ratio) as the firm performance measures. Specifically, they examined whether the change in these measures from one three-year period (2000-2002) average to the following (2003-2005) three-year period average, determined using a difference score, will have the predicted effect on Board composition and structure. For governance structure, they used change in the number of directors, outside directors, Board prestige, CEO power and tenure.

The results of Valenti et al., (2011) study provided evidence that the performance effects on Board composition are more dramatic when there has been a downward change in the firm’s performance. The prior negative change in firm performance was significantly related to a decrease in the overall number of directors and a decrease in the number of outside directors. One of the implications of this study is that the sample size used was relatively small and the focus was on small to medium-sized firms, so the results might not apply to firms larger than those used in their sample. Overall, the findings continued to follow the pattern established by prior studies; i.e., the relationship between performance and individual governance practices is weak, at best,
regardless of the causality. With respect to Board composition, social capital and network influences may be a much more important determinant of Board membership than monitoring concerns.

The research on Corporate governance and firm performance has mainly been conducted in developed economies; there has not been much empirical work done on this issue in India. Also the results of the studies conducted have not given consistent and robust results. There are only a few studies conducted in India testing the relationship between Corporate governance and firm performance; which have been discussed in detail in the next section 2.6.

2.4 Indian Studies

The Indian literature which has empirically tested the relationship between Corporate governance and firm characteristics is scarce. Consistent with worldwide studies, where no conclusive evidence to any one school of thought has been proved, same is the case with India; the findings of previous studies are mixed in nature.

Balasubramanian et al., (2010) examined the cross sectional relationship between Corporate governance and firm market value (Tobin’s q) by building a broad Indian Corporate governance Index (ICGI). They provided a detailed overview of the practices of publicly traded firms in India and identified the areas where governance practices are relatively strong or weak based on a 2006 survey of Indian firms. They relied on the survey and firm annual reports to construct an ICGI by identifying 49 firm attributes that are often believed to correspond to good governance, on which they had reasonably complete data,
reasonable variation across firms and sufficient difference from another element included in $ICGI$.

There was judgment involved on which elements were to be included in the index. Each is coded "1" if a firm has the attribute and "0" otherwise. They grouped these elements into indices such as: 1) Board structure (with sub-indices for Board independence and Board committees), 2) Disclosure (with sub-indices for disclosure substance and for auditor independence/disclosure reliability), 3) Related party transactions (with sub-indices for volume of RPTs and approval procedures), 4) Shareholder rights; 5) Board procedure (with sub-indices for overall procedure and for audit committee procedure).

According to their study, most of the sample firms meet the Board independence rules under Indian law, which require either 50% outside directors or 1/3 outside directors and a separate CEO and Board chairman, leaving 13% (38 firms of the sample firms aside). Firms are more likely to comply with audit committee requirement, although 1% does not. Related party transactions are common (67% of firms have RPTs representing 1% of more of revenues), but approval requirements for them are often weak. For transactions with a controlling shareholder, only 7% (1%) of firms require approval by non-conflicted directors (minority shareholders). However, 78% of firms nominally require RPTs to be on “arms-length” terms, and 94% disclose them to shareholders. Only about 2/3rds of firms provide annual reports on their websites. They found a positive and statistically significant association between $ICGI$ and firm market value.

Jackling and Johl (2009) investigated the relationship between internal governance structures and financial performance for a sample of 180 Indian
companies. The effectiveness of Boards of directors including their composition, size and aspects of Board leadership including duality and Board busyness had been addressed using two theories of Corporate governance: agency theory and resource dependency theory. They used ROA and Tobin’s q as the firm performance measures. The study takes into account the endogeneity of the relationships among Corporate governance, corporate performance and capital structure. The study provided support for some aspects of agency theory as a greater proportion of outside directors on Boards were associated with improved firm performance. The notion of separating leadership roles in a manner consistent with agency theory was not supported.

The findings suggested that larger Board size has a positive impact on performance, thus supporting the view that greater exposure to the external environment improves access to various resources and thus, positive impacts on performance. The study, however, failed to support the resource dependency theory in terms of the association between frequency of Board meetings and performance. Similarly, the results showed that outside directors with multiple appointments appeared to have a negative effect on performance, suggesting that busyness did not add value in terms of networks and enhancement of resource accessibility. The findings say that no single theory explains the nexus between Corporate governance and performance.

Kohli and Saha (2008) study analyzed the impact of Corporate governance mechanisms on valuations of selected companies in Fast Moving Consumer Goods and Information Technology sectors in India. The study was carried out for the period 2002–2006 because improvement initiatives of Corporate governance were undertaken during the period. The Corporate governance
mechanisms chosen for this study were Board structure, composition and management, committees, compensation, shareholder rights and value creation and social awareness. The panel data regression method has been used to examine the impact of Corporate governance factors on market valuation. Data consisting of a sample of 30 companies for the entire five-year period represent the database for this study. Results obtained showed an overall strong significant relationship between Corporate governance and market value of a firm. Of all the Corporate governance mechanisms studied, however, only shareholders’ rights and value creation for stakeholders emerged as important for impact on the valuation. The findings are expected to have practical implications for directors, owners and regulators to formulate the Corporate governance codes and guidelines.

Garg (2007) in his paper ‘Influence of Board size and independence on firm performance’ studied the relationship between Board independence, Board size and firm performance using ordinary least squares and random effects regression for a period of six financial years. He used ROA, Tobin’s q, Sales/Assets, market-adjusted stock price returns for quantifying firm performance. Further, he has also tested the impact of different Board size and independence categories on firm performance. The findings of the study suggested that there is an inverse association between Board size and firm performance. Different proportions of Board independence have dissimilar impact on firm performance. The impact of Board independence on firm performance is more when the Board independence is between 50 to 60 per cent. Smaller Boards are more efficient than the larger ones, the Board size limit of six suggested as the ideal.
The analysis of Garg (2007) study suggested that independent directors have so far failed to perform their monitoring role effectively and improve the performance of the Indian firms. The guidelines on Corporate governance should take into account the cross-Board phenomenon while defining the criteria for eligibility for appointment as an independent director. According to the author, lack of training to function as independent directors and ignorance of the procedures, tasks, and responsibilities expected of them could be reasons for the independent directors’ non-performance. A bad performance leads to an increase in Board size, which in turn, hampers performance. It was also found in his study that Board independence and firm performance are not endogenously determined but Board size and firm performance are endogenously determined.

In the same study, Garg (2007) analyzed the impact of firm performance on Board size and independence by regressing Board size and independence as dependent variables and different performance measures as explanatory variables. The coefficients with lag values of performance measures were also estimated as explanatory variables to see whether a bad performance that year led to a change in the Board size and independence the next year. He found firm performance to be inversely related to Board size and independence. This supports the argument of Hermalin and Weisbach (1988) that firm performance can alter the composition of the Board but they had not given the direction, i.e., whether a bad performance would increase or decrease the Board size. He argued that firms do tend to increase Board independence under adverse circumstances due to the pressure exerted by the stakeholders and on the assumption that adding of independent directors will bring in new expertise.
Similarly, the problematic independent directors are weeded out at the times of good performance when nobody cares to protest.

Ghosh (2006) examined the association between financial performance and Boards of non-financial firms. The study used ROA, ROE, Tobin’s q and Return on sales as the measures of firm performance and Board size, non-executive directors and CEO remuneration for Corporate governance. Using data on 127 listed manufacturing firms in India for 2003, the findings indicate that after controlling for various firm-specific factors, larger Boards tend to have a dampening influence on firm performance, judged in terms of either accounting or market-based measures of performance. In terms of policy implications, the analysis suggests that compensation of the CEO has a significant positive effect on the performance of the firm. Further, the study found positive association between number of non-executive directors and firm performance.

Dwivedi and Jain (2005) investigated the relationship between Corporate Governance and firm performance taking into account the endogeneity in the relationship. A simultaneous equation regression model for Tobin’s q, as a measure of firm performance, is attempted using these variables, while controlling for industry effects and other non-governance variables. The governance parameters included Board size, directors’ shareholding, institutional and foreign shareholding, while the fragmentation in shareholding is captured by public shareholding. The data was related to a panel of 340 large, listed Indian firms for the period 1997–2001 spread across 24 industry groups.

The findings of their study suggested that higher proportion of foreign shareholding is associated with increase in the market value of firm, while
Indian institutional shareholders’ association is not statistically significant. Weak positive association between Board size and firm value has been reported in the study. Directors’ shareholding was found to have a non-linear negative relationship with firm value, while the public shareholding has a linear negative association.

Kathuria and Dash (1999) examined the association between Board size and corporate financial performance using data on 504 corporations belonging to 18 industries. The financial performance is measured as the return on assets of the corporation. To account for the possibility that a variety of other factors can affect the profitability and thus, omission of these may result in spurious correlation between Board size and financial performance, a number of other factors have been included in the investigation. The study uses the Centre for Monitoring Indian Economy (CMIE) database, for the year 1994-95. The results suggested that Board size plays an important role in influencing the financial performance of corporations. The analysis showed that the performance improves if Board size increases, but the contribution of an additional Board member decreases as the size of the corporation increases. The results, however, failed to indicate any significant role of directors’ equity ownership in influencing the performance.

In the last two decades, there has been an increased intensity of research on the relationship between Corporate governance and firm characteristics. But it can be seen that the issue has mainly been explored in developed economies (Hermalin and Weisbach, 1991; Kang and Shivdasani, 1995; Gompers et al., 2003; Judge et al., 2003; Barnhart et al., 1994; Bauer et al., 2004; Christopher, 2004; Bhagat and Bolton, 2008; Guest, 2008). The empirical work on this issue
is still at its infancy in India, maybe due to the relatively opaque disclosure practices followed by Indian companies or the data unavailability problem.

2.5 Key Observations and Research Gap

The objective and focus of corporate governance is on obtaining sustainability and achieving corporate responsibility at all the managerial levels within an organization (Aggarwal, 2013). Corporate governance depicts a set of relationships among company’s management, its board members, shareholders and other significant stakeholders. In addition, it provides the mechanism through which the issues and concerns of corporation stakeholders, such as the shareholders, creditors, management, employees, consumers and the public are listened to and resolved as well (Effross, 2010). Good governance enhances the performance of an organization’s employees and therefore, facilitates its growth and development. The development of the organization will in turn have a positive impact on the country’s economy. It is mentioned that corporate governance revolves around the relationship among the external stakeholders and internal stakeholders (Monks & Minow, 2011).

Sarkar and Samanta (2015) conducted their research to understand the alignment between the corporate governance and firm performance of 30 Sensex companies of India, for which they investigated factors such as board size, independent directors’ presence in the board, audit committee’s size and independent directors’ attendance in the audit committee. For this purpose, the researches deployed Tobin’s Q method for evaluating the firm performances. The results, however, were not conclusive but revealed that financial performance of a firm cannot be acquired with poor governance.
Palaniappan and Srinivasa (2016) investigated the relationship between the approaches of corporate governance disclosure and firm performance in the Indian stock exchange market. The researchers used annual reports of firms to acquire the data and after conducting statistical analysis (correlation and regression), they revealed that the corporate governance disclosure has a significant impact on the performance of the manufacturing firms of India.

Rajput and Bharti (2015) conducted their study to evaluate the relationship between the corporate governance, shareholder types and firm performance. For this purpose, the researchers used panel regression and measured the firm performance through Tobin’s Q, ROA, ROE of 100 Indian companies. Their results revealed that the foreign institutional investors (one of the stakeholder type) and family ownership had a positive relationship with ROE. On the other hand, the government and retail stakeholder had a negative impact on ROE.

There is an extensive literature pertaining to corporate governance and its effect on firm performance, cost of capital and capital structure and dividend policies individually. Specifically, in India, the available literature focuses on evaluating the firm performance on the basis of the impact of corporate governance. None of the studies have focused on evaluating the relationship between all these variables in Indian firms. There are no conclusive evidences so far that have revealed the true impact of corporate governance on these variables. Therefore, the present study aims at determining the quality of corporate governance and its effect on companies’ capital structure, cost of capital, dividend pay-out/policy and firm performance, while evaluating the factors such as ownership structure, board size and number of board members.
Most of studies have been reported from developed counties like USA, and Britain. The authors Abor, Biekpe, Klock and Wen have been more active. Large number of studies has been conducted during 2007, 2009 and 2011. In Indian context Balasubramanian and Garg have conducted good number of studies though still lesser compared to international studies. Furthermore, this study attempts to fill a gap in the literature by illuminating the significant links between corporate governance and different firm performance characteristics of companies in India.

The next chapter presents the methodology used to test the research framework and construction of the model for estimating the relationship between Corporate governance and other firm characteristics. It discusses the data collection procedure, variable specification as well as the estimation issues.