CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the studies pertinent to mandatory, non-mandatory and other Corporate Governance (CG) practices. The area of CG became a fertile field of research after the Cadbury Committee Report in the United Kingdom (UK) in 1992. In emerging markets, CG has not been studied as intensively as in developed markets. Outside the United States (US), i.e., in Japan and Germany, limited research has been carried out on CG. Since economic reforms, CG has gained momentum in India. Gopal has contended that establishment of various committees on CG initiated the adoption of CG practices in India. Good CG addresses the need for disclosure, transparency and professionalism by managers, shareholders, foreign institutional investors and financial institutions. According to Balgobin, the number of scholarly and peer-reviewed articles on CG has gone up from 207 and 434 in 1985-1995 to 2,418 and 7,299 for the period 1996-2006. Agarwal stated that companies in India have opportunities as well as threats worldwide due to entry of global companies. There is a growing realization that good CG is a must not only for credibility and trust but also as a part of strategic management for the prosperity and sustainability of business. According to Stijn and Fan, enormous research work is being done on CG in Asia, excluding Japan but most of the work is based on the literature available on CG from the western countries particularly, US. Khanna and Palepu analyzed the CG practices of an Indian
firm i.e., Infosys Technologies and they argued that the globalization of product and talent markets have affected CG of firms. Influence of such individual firms as the role model of good CG may be a positive externality on the rest of the Indian firms and may accelerate convergence of CG. Kimber et al., analyzed CG in four Asia Pacific countries viz., Australia, China, India and Singapore. The said countries have significant diversity in terms of social, cultural, economic developments and approaches to CG. One common feature found is the high concentration of ownership by national governments and families, and such concentration had peculiar effects on the stock market and protection to minority shareholders.

2.2 The Tangible Worth of CG

According to a McKinsey survey of institutional investors around the world, investors are ready to pay a premium of up to 28 per cent for companies having good governance. A joint study by Georgia State University and Institutional Shareholder Services found that the best-governed companies had mean returns on investment and equity which were 18.7 per cent and 23.8 per cent respectively better than poorly governed companies.

2.2.1 CG, PERFORMANCE AND FIRM VALUATIONS

A three-member committee constituted by the Ministry of Finance has studied CG of 30 large Indian public companies and ascertained that profits are not related with CG. But, Black found that market value of companies depends crucially on the quality of CG. Using CG rankings, he predicted a seven-hundred-fold increase in firm-value

---

* Convergence means harmonization of CG regulations among various countries.
from worst to best governance. Klapper and Love studied over 400 companies in 25 emerging economies and found that CG practices are highly correlated with firm market valuations.\textsuperscript{14} Gompers, Ishii and Metrick in US also reported similar findings.\textsuperscript{15} According to Gompers et al., portfolios of companies with stronger shareholder-rights protections outperformed portfolios of companies with weaker protections by 8.5 per cent annually. Moreover, superior CG is associated with higher operating performance and higher valuations.\textsuperscript{16} Durnev and Kim found that good CG is positively correlated with firm value.\textsuperscript{17}

2.3 Models of CG in India

Varma feels that the Anglo-Saxon (Anglo-American) Model of CG is not particularly suitable to the Indian context.\textsuperscript{18} As all CG models survived and the economies prospered, the CG models of Japan and Germany are equally good.\textsuperscript{19} Evolving arguments evidently do not settle the question as to which model of CG is more efficient. Recent research has shown that historically, political pressures are as important in the evolution of CG models, as the economic ones. Balasubramanian advocated that our own ancient texts have laid down sound principles of CG which are relevant in the present context too.\textsuperscript{20} However, in India, policy-makers are adopting the Western models of CG, policies, and regulations without checking their feasibility in the Indian context. So, the suitability of CG norms may not be so expeditious in emerging markets. To provide adequate investor protection for enforcement of CG rules in India, key concerns are overburdened courts and significant corruption though, on paper India provides the highest levels of investor protection in the world.\textsuperscript{21} CG in India does not compare
unfavorably with, and in many respects represents a major improvement over the CG models of, the other major emerging economies notably Brazil, Russia and China.\textsuperscript{22} No CG model is proven to be effective in all circumstances.\textsuperscript{23} Even the Anglo-Saxon Model has its own flaws which are apparent from the corporate scandals of prominent companies viz., Enron and WorldCom. Gilson suggests the possible emergence of a globally accepted CG model, relatively uniform in functions despite persisting formal differences.\textsuperscript{24} The Indian corporate sector offers both the best and worst kind of CG models.\textsuperscript{25} CG in Indian Boards is apparently driven by its collective conscious and not by stakeholders' demands or market forces.

2.4 Code of Conduct

A code of conduct is one of the internal governance mechanisms used by Boards to ensure ethical behavior in corporate conduct. As per Clause 49 of the Listing Agreement, the code of conduct is a mandatory CG norm in India for listed companies since January 2006 (i.e., with effect from the quarter ended March 31, 2006).\textsuperscript{26} Even before 2006, a good number of Indian companies had a code of conduct for their top managers. According to Laczniak and Murphy, a code of conduct should be specific (in terms of guidance), pertinent (to the industry) and enforced (contain sanctions) to be an effective, i.e., ideal one.\textsuperscript{27} The scholars also found that the codes of a majority of Indian firms are nowhere close to \textit{`an ideal code`} because they fall short of the conditions contained in the ideal code.
2.5 Convergence of CG Structures

According to Demb and Neubauer, the Board structures in Germany and Japan are moving towards the US structures of a single-tier Board. A single-tier Board is relatively smaller and has both insiders and a significant number of Independent Directors. Yoshimori indicated that the signs of partial convergence of CG are observable among Japanese firms. Kanda argued that shareholding based on ‘friendly-ties’ i.e., relationships-driven, does not work well in Japan anymore and it is now more market-driven. Meanwhile, developing countries too are moving towards the Anglo-Saxon Model. This view is also confirmed by Mukherjee-Reed, who argued that this change is led by modifications in the legal and regulatory systems. Hopt suggested that large enterprises will fall in line with CG practices adhered to by the US companies. Coffee also agrees that convergence would happen. Hansmann and Kraakman also believe that the global CG systems are converging towards the Anglo-Saxon Model. As this model focuses on shareholders’ interests, they argued that shareholder primacy will predominate as legal provisions can protect the interests of the other stakeholders. Moreover, the competitive pressures of globalization may accelerate the process of convergence. Wojcik concluded that ownership concentration of German firms from the year 1997 to 2001 had fallen significantly. He indicated that the German firms have started dissolving the cross-holdings and that financial sector institutions have declined in importance as block-holders. German firms are also moving towards the Anglo-Saxon Model. According to Gugler et al., the Japanese financial sector was deregulated and in recent years, the members of Keiretsus reduced their cross-holdings. Besides, a large number of Japanese firms are getting listed on either New York or London Stock
Exchanges and such listing signals a move towards convergence. However, another set of researchers argue that the CG mechanisms of countries will never converge, because of path dependence of the economies; and Bebchuk and Roe identified two sources of path dependence i.e. *structure-driven* and *rule-driven*. Structure-driven path is concerned with existing basic corporate ownership structures in a country whereas rule-driven path is concerned with financial and corporate regulations which in turn are influenced by the initial corporate structure. As a consequence of path dependence, convergence of the corporate laws will not be as fast as required. According to Gilson, a third set of researchers’ perspective is *functional convergence*. At the outset, functional convergence occurs when institutions can respond to market participants with flexibility, without altering their own formal characteristics. For instance, according to Bris and Cabolis, the creation of new stock exchanges in Europe gives protection to investors as companies are bound to comply with norms of stock exchanges irrespective of provisions provided by other laws. Second, *formal convergence* occurs when legislative action forces the adoption of best practices and thereby alters the basic structure of the existing governance institutions. Third, *contractual convergence* occurs when companies change their own CG practices by committing to adhere to a better regime as the existing provisions of CG for compliance lack flexibility to respond with a formal change. According to Khanna *et al.*, globally accepted CG norms laid down by a number of standards-setting bodies and multilateral institutions, as for instance, Organization for Economic Co-operation and Development, to foster good CG globally is a testimony to the heightened interest in the convergence issue.
2.6 Ownership

2.6.1 CG, INSIDERS’ OWNERSHIP AND PERFORMANCE

Gompers et al., have uncovered a strong relationship between CG and firm performance.\(^{41}\) Phani at el., found that in the Indian context, the influence of insiders’ ownership on the performance of the firm is sporadic in nature.\(^{42}\) The association of insider ownership with performance could be considered as temporary aberrations and would disappear in a short time span. The study by Mujumdar and Chhiber revealed a significant negative relationship in India between the levels of debt in the capital structure of the firm and performance.\(^{43}\) They argued that both short-term and long-term lending institutions are government-owned and it could be the reason behind this relationship. They advocated that CG mechanisms in the west would not work in the Indian context unless the supply of loan capital is privatized. Singh studied the ownership pattern of 14 major Indian companies and revealed that promoter-shareholders are dominant owners, owning 33 per cent to 85 per cent of the total share capital.\(^{44}\) The ‘Principal-agent’ relationship is thus considerably diluted in this model, as the interest of promoters substantially converges with retail shareholders. Morck et al., observed a positive relationship between Board ownership, ranging up to 5 per cent and firm performance but a negative relationship for the 5 per cent to 25 per cent ownership range, indicating that as ownership stakes rises, management entrenchment outweighs convergence of interest, and the positive influence of management ownership re-appears only beyond the 25 per cent ownership range.\(^{45}\) According to Agrawal and Knoeber, higher insider ownership was positively related to performance.\(^ {46}\) Murphy (1999) and Core et al., (2001) as well as Holderness found that the relationship between inside
ownership and performance is mixed.\textsuperscript{47} Khanna and Palepu have detected a positive linear relationship between insider ownership and performance of the firm in a single year, 1993, where both accounting (Return on Assets) and market based performance measures (Tobin’s Q) were used.\textsuperscript{48} Van \textit{et al.}, found that equity ownership of management Board and supervisory Board does not affect performance.\textsuperscript{49}

\textbf{2.6.2 MANAGERIAL, INSTITUTIONAL, GOVERNMENT OWNERSHIP AND FIRM PERFORMANCE}

For more than 70 years, since the classic work of Berle and Means which gave the proposition that ownership and control in the modern corporation have been separated, researchers have been trying to identify the optimal ownership structure and how it influences a firm’s subsequent performance.\textsuperscript{50} According to Jensen and Meckling, managerial ownership can be an effective governance mechanism because it can align the interests of managers and shareholders and hence a positive correlation is expected.\textsuperscript{51} In consonance with this, Agrawal and Knoeber upheld ownership as an important CG mechanism.\textsuperscript{52} In another study by Chrisotomos, it was observed that at low levels of shareholding by managers, managerial ownership binds managers and outside shareholders to pursue a common goal by decreasing managerial incentives for extravagant rewards, encouraging diligence and the launching of good projects (\textit{alignment effect}).\textsuperscript{53} However, after some level of ownership, managers put in insufficient efforts, amass personal wealth and establish themselves at the cost of others (\textit{entrenchment effect}). Hence, managerial ownership as a governance mechanism can be used to control the actions of managers. According to Jensen and Meckling, there occur two opposing effects of managerial ownership - the interest and the entrenchment
effect. Under the interest effect, correlation between managerial ownership and firm’s performance is positive as the managers have to share the cost of their actions. In the entrenchment effect, this association turns negative as managers have a large stake in the organization and thus overlook the interests of other shareholders. The seminal work by Morck et al., studied the relationship between managerial ownership and Tobin’s Q (proxy for market value). An inconsistent relationship was observed as Tobin’s Q increased with ownership, suggesting the convergence of the interests of agent and principal, whereas a decrease would have suggested entrenchment effect in play. According to Mudambi and Nicosia, ownership concentration and the extent of investor control have entirely dissimilar effects on a firm’s performance. They also found an inconsistent relationship between managerial stock-holding and firm performance, supporting both the theories of entrenchment and interest. A study by Welbourne and Cyr identified three types of ownership i.e., ownership by the Chief Executive Officer (CEO), by the top management and by all the employees of the firm. The study suggested that an increase in ownership of all the employees will have a positive impact on a firm’s performance, whereas increases in CEO and top management ownership will have a negative impact on firm’s performance. Core and Larcker found that after a compulsory increase in managerial share ownership, prior to the adoption of the managerial share ownership plan, firms reported a lower performance as compared to other firms without such plans. They also established that share price return was highest in the first half of the year in which the announcement of the managerial share ownership plan was made and that firm performance improves after managers with less stock ownership are required to mandatorily increase their stake. Jahmani and Ansari used accounting
measures and correlation analysis (instead of stock returns) and observed no effect of ownership on a firm’s performance, risk taking abilities of managers and on motivation levels of managers to work more competently.\textsuperscript{59} Demsetz and Lehn did not find any significant relationship between profitability and ownership concentration.\textsuperscript{60} However, Zeitun and Gang found that there was a positive impact of managerial ownership on a firm’s performance in Jordan.\textsuperscript{61} Another study by McConnell and Servaes studied the relationship between Tobin’s Q and ownership, in which a significantly positive relationship was found.\textsuperscript{62} Ming-Yuan Chen found that association of the family in management of the firm determines the option of ownership stakes in Taiwan.\textsuperscript{63} It was also found that entrenchment effect engulfs incentive (interest) effect at a higher level of ownership. According to Short and Keasey, a non-linear relationship existed between managerial ownership and firm performance for UK companies due to possible effects of alignment and entrenchment.\textsuperscript{64} However, the exact relationship between a firm's managerial ownership and performance is still ambiguous. The relationship is either positive or non-existent. This justifies the need for further research.

According to Chaganti and Damanpour, there exits limited research about the impact of institutional ownership on firm performance as it is assumed that there is no significant relationship between the two.\textsuperscript{65} Capital structure and Return on Equity were found to be considerably related to the amount of shareholding by institutional investors. The stakes also impact firms’ Return on Assets, and Price-Earnings Ratio in varying degrees. It was observed that ownership structure had no substantial impact on total stock return. Another study found the institutional ownership to be negatively related with growth but positively related with profitability.\textsuperscript{66} Public ownership did not show any
significant relationship with any of the performance variables. Financial Institutions’ ownership showed significant and positive relation with assets creation. However, Roy found that the stake of financial institutions had a negative relationship with profitability. Chhibber and Majumdar found that three types of state ownership exist in India: firstly, firms where the government has less than 26 per cent shareholding; secondly, where the government owns more than 26 per cent; and lastly, where state is the majority shareholder with more than 50 per cent share. The study revealed that firms which do not have state as the majority shareholder performed better. But, another study by Ahuja and Majumdar, involving 68 state-owned firms revealed that the firms on average were less effective in employing their resources. In India, Kumar studied more than 2,000 publicly traded enterprises and found that foreign shareholding does not influence the performance of the firm significantly, contrary to the other studies. He also found that the extent of ownership by financial institutions positively influences a firm's performance. However, no significant difference was found in managerial ownership and firms’ performance across group and stand-alone firms. According to Pant and Pattanayak, ownership in India is concentrated in the hands of family members and their relatives. The findings suggested that when insider ownership increased from 0 per cent to 20 per cent, firm value also increased and as the stake increased further from 20 per cent, the entrenchment effect came into play so the performance deteriorated; further, when the ownership extended beyond 49 per cent, there was a convergence of interest with the firm and again the performance improved. According to Hambrick and Jackson, outside director holdings were actually associated with corporate performance changes subsequent to such holdings.
2.6.3 INSIDE OWNERSHIP, CASH FLOW RIGHTS, AND TUNNELLING

Jensen and Meckling demonstrated that reduction in owner-manager’s equity tends to encourage appropriation of corporate resources in the form of perquisites and consequently, reduction in the claim of stakeholders on the cash flow without equivalent reduction in control rights.\textsuperscript{73} Such behaviour gives rise to agency costs. According to La Porta \textit{et al.}, a need for higher cash flow ownership by managers shows a commitment to control expropriation and it is higher in countries with inferior shareholder protection.\textsuperscript{74} Bertrand, Mehta and Mullianathan concluded that differential control and cash flow rights encourage undue appropriation or tunnelling of profits.\textsuperscript{75} The authors focused only on firms belonging to large groups but controlled by an ultimate owner through a pyramidal ownership structures\textsuperscript{*} and contend that transfer pricing which affects the operating profit of the firm is not an important source of tunnelling in India. They found significant amounts of tunneling, mostly via non-operating components of profits. Bennedsen and Wolfenzon argued that when investor protection is poor, dissipating control among several large investors might be useful to limit expropriation.\textsuperscript{76} Bertrand, Mehta and Mullianathan reported that industry shocks result in 30 per cent lower earnings growth for business group firms than for stand-alone firms in the same industry.\textsuperscript{77} The companies farther down the pyramidal structure were less affected by industry-specific shocks than those nearer the top, suggesting that shocks in the former are effectively buffered using the assets and cash flows of the latter, benefiting the

\textsuperscript{*} Pyramidal structures allow the ultimate owner to end up with control of all the firms in the pyramid with little or no cash flows. This is possible as the owner holds controlling share in one firm and then this firm holds controlling share in another firm and so on and so forth thus gaining control of a set of firms by having a controlling share in one firm at the head of the pyramid.
controlling shareholders at the cost of minority shareholders. On the other hand, Khanna and Yafeh question how such a practice would insulate them from industry shocks in the long-term. Moreover, according to Khanna and Palepu, companies associated with business groups outperform stand-alone companies. Kali and Sarkar argued that diversified business groups help to increase the opacity within group fund flows, driving a broader wedge between control and cash flow rights, and providing more opportunities for tunnelling. The authors further reported that business group companies with greater ownership opacity and a smaller disparity between control and cash flow rights than those in a group’s core activity were likely to be located farther away in the pyramid from the core activity and hence were the most likely to receive tunnelled cash flows and assets. According to Saha, after controlling for other CG characteristics, firm performance was negatively associated with the extent of related-party transactions for group firms but it was positive for stand-alone companies – a circumstantial evidence on tunnelling and its adverse impacts. The study further showed that group companies consistently report higher levels of related-party transactions than stand-alone companies. Most related-party transactions in India occur in case of joint ventures, subsidiaries and associate companies while in the US, the counterparties tend to be the firm’s own management personnel.

2.6.4 CONTROL AND INVESTOR PROTECTION

La Porta et al., argued that entrepreneur firms may wish to keep control of their firms with them when investor protection is poor. Claessens et al., examined 3,000 firms from nine East Asian economies and found that except Japan which has fairly good
shareholder protection, family control and family management is pre-dominant with some state-control.\footnote{83}

2.6.5 OWNERSHIP CONCENTRATION, PERFORMANCE AND OTHER IMPLICATIONS

Gugler made a survey of the studies of US and UK firms and showed that owner-controlled firms (with a single block of equity exceeding 5 per cent or 10 per cent) significantly outperformed manager-controlled firms.\footnote{84} Cross-sectional analysis by Wruck indicated that the change in firm value on the announcement of a private sale is strongly correlated with the resulting change in ownership concentration i.e., it is positive when ownership concentration is high or low, but negative in the mid range.\footnote{85} A study of German firms by Thonet and Poensgren found that manager-controlled firms significantly outperformed owner-controlled firms in terms of profitability, but owner-controlled firms had higher growth rates.\footnote{86} Holderness and Sheehan found that the frequency of corporate-control transactions, investment policies, accounting returns and Tobin’s Q were similar for majority shareholders owned and widely-held firms.\footnote{87} In India, shareholding patterns revealed a marked level of concentration in the hands of the ‘promoters’, i.e., the founding and controlling shareholders. Sarkar and Sarkar reported that promoters own over 50 per cent of a sample of almost 2,500 listed manufacturing companies.\footnote{88} Sarkar and Sarkar also reported that equity stakes above 25 per cent by directors and their relatives were associated with higher valuation of companies and there was no clear effect below that threshold.\footnote{89}
2.6.6 FAMILIAL OWNERSHIP, TAKEOVERS AND PERFORMANCE

According to McConaughy et al., family-controlled firms in US had greater value, were operated more efficiently and had fewer debts than other firms. However, Jacquemin and Ghellinck and Prowse reported no relationship between performance and familial ownership in case of French and Japanese firms. Agrawal and Knoeber found that greater corporate control activity (number of takeovers within industry) was negatively related to performance. Interestingly, Gugler had shown that there exists active markets for corporate control in the US and UK, unlike in Continental Europe or Japan. According to Franks and Mayer, takeovers are an incomplete mechanism to solve the basic agency problem in large public corporations, say, in the US and hostile takeovers were attempted for other reasons than poor performance. In Hong Kong, Ng found that family ownership affects a firm’s performance.

2.7 The Board of Directors

2.7.1 THE ROLE OF THE BOARD AND DIRECTORS

According to a survey by Dutta, Boards have no active role in the governance of a firm and Board members merely endorse their approval to proposals. Also, the Nominee Directors are treated indifferently and they hardly have any say in the Board meetings. Directors in most of the companies are ineffective in monitoring the management’s performance. According to Varma and Dalal, the members of the Board do not play the role that they are supposed to play. For instance, the existence of Audit Committees does not guarantee good CG. Zingales, La Porta et al., and Bebchuk argued that if entrepreneurs disperse control among many investors, then they give up the
premium of private benefits in a takeover.\textsuperscript{99} Two decades of research reveals that in any Board related decision making, when the Board has a majority of Independent Outside Directors, the outcome is more likely to favour shareholders.\textsuperscript{100} Also the representations made by large shareholders on the Board have a positive impact on CG. Though frequent Board meetings facilitate better communication between management and directors, such frequency may distract Board members as they usually have a busy schedule. A very large Board can be dysfunctional and companies which enjoy the highest valuation seem to have compact Boards. As Shivdasani and Zenner put it: “Companies with the highest valuation multiples had Boards that include 8 or fewer people, while companies with Board membership of more than 14 displayed the lowest multiples.”\textsuperscript{101} Further, directors should not serve on too many Boards. A person holding full-time employment is considered “busy” if he serves on more than 3 Boards and a retired person is considered “busy” if he serves on more than 6 Boards.

2.8 Board Characteristics

The most important internal CG mechanism is the Board because other internal governance mechanisms largely depend on the effectiveness of the Board. The widely studied Board characteristics are the size of the Board, proportion of Independent Directors in the Board and firm performance. The other factors like profile of the directors also figured in some studies.
2.8.1 BOARD MONITORING, QUALITY OF DECISION MAKING, SIZE OF BOARD AND FIRM PERFORMANCE

Monks and Minow argued that Board monitoring may lead to better quality of managerial decisions.\textsuperscript{102} Fama and Jensen also argued that Boards can be effective mechanisms for monitoring management.\textsuperscript{103} Boards effect appointments of management personnel and also their rewards, suspensions and dismissals and such managerial decisions have implications on corporate performance. A study by Weisbach was one of the earliest to report an association of Board turnover, firm performance and the presence of outside directors.\textsuperscript{104} Fama argued that the viability of the Board might be enhanced by the inclusion of outside directors.\textsuperscript{105} The Cadbury Committee Report UK, suggested more number of Non-Executive Directors in the Board in addition to the separation of the post of Chairman and CEO.\textsuperscript{106} Weisbach found that performance measures are highly correlated with CEO turnover for firms in which outsiders dominate than insiders’.\textsuperscript{107} Bhagat and Black also reported a positive impact of the number of outsiders.\textsuperscript{108} Pearce and Zahra and Dalton \textit{et al.}, found a positive association between the Board diversity and firm performance.\textsuperscript{109} A larger Board with diverse backgrounds can bring knowledge and intellect to improve the quality of decisions. Simultaneously, as the larger Board will also have group dynamics, it can also diminish the Board effectiveness on account of problems of co-ordination. Goodstein \textit{et al.}, Yermack, and Eisenberg \textit{et al.}, supported this argument.\textsuperscript{110}

In the Indian context, some research work has shown that the larger Boards improve performance till a threshold level, while others argue that larger Boards are inefficient. According to Kathuria and Dash, performance improves if the Board size
increases. Their results, however, failed to indicate any significant role of directors’ equity ownership in influencing the performance. A larger Board size creates more opportunities and resources for better financial performance. According to Kautilya, the Board size should be according to the requirements of place, time and nature of the work in view. These findings are also supported by Dhawan. According to him the size of the Board increases with the turnover but only up to certain level, beyond which the increasing turnover does not have any influence. The researcher found that effective integration of the skills and knowledge base of the Board is more important than size. Further, he advocated that there is no need to have informal meetings of the Board but it is vital to finalize the agenda in order to have effective Board meetings. The core competencies required for the directors are strategic thinking and leadership qualities besides honesty and integrity. Dwivedi and Jain also found a positive but weak relationship between Board size and firm value. The results revealed that a higher proportion of foreign shareholding is associated with rising market value of the firm, while the association of Indian institutional shareholding with market value is not statistically significant. While directors’ shareholding had a non-linear negative relationship with the firm value, the public shareholding had a linear negative association.

A few empirical results suggest that Board size exerts a negative influence on corporate performance irrespective of whether accounting performance or market based measures are considered. Board size has been widely demonstrated as being negatively associated with lower returns to investors, suggesting larger boards are less effective monitors. Such findings are supported by Bharadvaja, Visalaksha, Parasara and Pisuna. Garg found that Board size and firm performance were inversely related.
Kaur and Gill found that the results of one-way ANOVA test for the comparison of means for Board size categories reveals an inverse relationship between board size and corporate performance.\textsuperscript{120} Prasanna, who employed factor analysis, suggested that Independent Directors bring brand credibility and better governance, contribute to effective Board functioning, and lead the governance committees’ effectively.\textsuperscript{121} The study supported two major recommendations of the Irani Committee i.e., one-third of the Board should be Independent Directors and nominees should not be considered as Independent Directors.\textsuperscript{122} He also highlighted the need for a formal process of the appointment of Independent Directors and their periodic evaluation. Mayur and Saravanan studied the relationship between three Board parameters and performance of banks in India.\textsuperscript{123} The authors indicated that bank value is not affected by Board size. According to Perry and Shivdasani, the Board of directors is one of the most important mechanisms used by the shareholders to monitor management.\textsuperscript{124} They further state that “charged with hiring, evaluating, compensating and ongoing monitoring of the management, the Board of directors is the shareholder’s primary mechanism for oversight of managers.” According to Finegold \textit{et al.}, firstly a Board performs an institutional function in which it links the firm and the external resources, secondly it is an important mechanism to check managerial opportunism and lastly, the Board performs a strategic role by involving itself in strategy formulation.\textsuperscript{125} Hej and Mahoney argued that if a CG mechanism is in place, managers will probably formulate optimal strategic policies leading to sustainable competitive advantage else managers could end up making sub-optimal strategies.\textsuperscript{126} Their research suggests a positive relationship between a firm’s capabilities and its competitive behaviour but this relationship is moderated by CG
mechanisms. Moreover, a positive relationship is indicated between competitive behaviour and firm’s performance. As the Board can directly influence a firm’s capability, it can influence a firm’s competitive behaviour and hence the firm’s performance positively. According to Barney, drawing on the resource-based view of the firm, a resource could be considered as a competitive advantage if it is rare, creates value for the firm, is inimitable and not easily substitutable.\textsuperscript{127}

Erakovik and Goel argued that if the Board of Directors is involved in acquiring knowledge and in the provision of resources, it will lead to exchange of information, both inside and outside the Board, resulting in a more open and collaborative relationship between the Board and management.\textsuperscript{128} This will build a unique CG structure, like a resource for the firm. According to Barney, the Board of Directors can work as a resource, leading to a competitive advantage for the firm and thereby enhancing performance of the firm.\textsuperscript{129} Chahine and Filatochev found that Initial Public Offer (IPO) discount is negatively associated with Board independence.\textsuperscript{130} IPO discount is also negatively associated with disclosure of information but up to a certain point. As more and more information was disclosed, investors thought it to be an attempt by the management to impress and induce them to acquire their shares. Raheja found that the Board size and composition could affect the performance of the firm.\textsuperscript{131}

According to Warther, a Board is ineffective if there is no dissent in the Board.\textsuperscript{132} Moreover, it was found that there is reluctance among the Board members in voting against the management but once an initiative is taken by somebody, it results into a bandwagon effect. It was also argued that the Board will be effective when it possesses more information which is possible when there are more outside directors on the Board.
Klein found that there is a negative relationship between the Audit Committee independence and Board independence vis-à-vis abnormal accruals.\textsuperscript{133} If the number of Independent Directors on the Board or in the Audit Committee decreased, there was an increase in the abnormal accruals. Therefore, the independence of the Board and Audit Committee can increase the Board’s effectiveness which can improve the firm’s performance. Adjaoud \textit{et al.}, found no significant relationship between Board characteristics and performance when traditional performance measures like Return on Assets (ROA), Return on Investments (ROI) and Earnings Per Share (EPS) were used.\textsuperscript{134} However, this relationship was significant when performance was measured in terms of Market Value Added or Economic Value Added. Jensen found that large Boards can be less effective than small Boards.\textsuperscript{135} When Boards members are as many as seven or eight, they are less likely to function effectively. Therefore, it can be said that size of Board affects the performance of the firm. Van \textit{et al.}, Netherlands, found that size of management Board has no impact on performance, size of the supervisory Board had a negative impact on performance and the number of outsiders negatively affected performance.\textsuperscript{136} In the Indian context, Tuteja recommended that Board size should neither be too small nor too large i.e., the ideal size should be from 6 to 10 directors.\textsuperscript{137} An ideal Board is a judicious mix of inside and outside directors. In the Indian context, Garg reported a negative relationship between the Board independence and performance as well as between Board size and performance.\textsuperscript{138} However, Halebian and Finkelstein argued that a large Board has more problems solving capabilities.\textsuperscript{139}

Several studies have been conducted to see how the characteristics of the Board impacts management and can enhance the performance of firms. However, there is no
consistency in the findings. Some studies found a positive relationship between Board characteristics and firm performance; some reported no relationship, while other studies reported a negative relationship. This emphasizes the need for further research.

2.8.2 INDEPENDENCE OF THE BOARD AND FIRM PERFORMANCE

Baysinger and Butler, and Hambrick and Jackson found that the proportion of Independent Non-Executive Directors is positively correlated with the accounting measures of performance. On the other hand, studies by Klein, Bhagat and Black, and Hermalin and Weisbach found that a high proportion of Independent Directors does not predict a better accounting performance. Using accounting measures, Agrawal and Knoeber found a negative relationship between Board independence and firm’s performance. Hermalin and Weisbach, and Bhagat and Black used the approach of Tobin’s Q as a performance measure on the grounds that it reflects the ‘value added’ of intangible factors and found that there is no noticeable relationship between the proportion of outside directors and Tobin’s Q. The study by Lawerence and Stapledon produced no consistent evidence that the preponderance of Independent Directors either adds or destroys value when corporate performance was assessed using accounting and share-price measures. Hermalin and Weisbach found that the proportion of Independent Directors increased when performance of a company was poor. Apparently, there is a link between Board size and independence. Perry and Shivdasani found that when the outside directors were in a majority, the likelihood that restructuring activities will be carried out was high and improvements were found in the performance of the firms subsequent to restructuring. As pointed out by Lipton and Lorsch the norms of behaviour in most Boardrooms are dysfunctional as directors rarely criticize the
policies of the top managers or hold candid discussions about corporate performance.\textsuperscript{147} Believing that these problems increase with the number of directors, they recommended limiting the membership of Boards to ten members, with a preferred size of eight or nine. They, in a way, suggested that even if Board capacities for monitoring increase with the Board size, the benefits are less as slower decision making, less candid discussions about managerial performance and risk aversion are costly affairs. When Boards become too big, agency problems increase and the Board becomes more symbolic and less effective. Yermack, Eisenberg, Sundgren and Wells, Mak and Kusnadi, Alshimmiri, and Andres, Azofra and Lopez had also reported the inverse relationship between Board size and performance.\textsuperscript{148} However, Dalton \textit{et al.}, came up with contrary results.\textsuperscript{149} Dalton and Kesner in a study of the 50 largest firms in the US, the UK, and Japan found that the proportion of insiders in Boards varied significantly between these three countries i.e., 30 per cent, 34 per cent, and 49 per cent respectively.\textsuperscript{150} Beasley analyzed 75 fraud-hit and 75 no-fraud firms and indicated that no-fraud firms had Boards with a significantly higher percentage of outside members than fraud-hit firms.\textsuperscript{151} Additionally, as outside director ownership in the firm and outside director tenure on the Board increased and as the number of outside directorships in other firms held by outside directors decreased, the likelihood of financial statement fraud also decreased. Geddes and Vinod and Weisbach found that with respect to the removal of poorly performing CEOs, a majority of independent Boards were likely to act more quickly.\textsuperscript{152} McNulty and Pettigrew interviewed 108 UK directors and found that part-time Board members did not simply ratify decisions made by all powerful executives, and that they were able to influence the processes of strategic choice.\textsuperscript{153} Mikkelson and Partch found a correlation between Board
composition and CEO tenure during the high-takeover period of 1983-1988. Rosenstein and Wyatt pointed out that a small increase in stock price was correlated with the addition of an outsider to the Board, which could be on account of a signalling effect. However, Chugh, et al., contend that an excessively autonomous Board with a high proportion of Independent Directors lowers profitability. One possible rationale was that the Boards were expanded for political reasons to include politicians, environmental activists or consumer representatives, and they either reduced firm performance or failed to contribute positively. Baysinger and Hoskisson found that outsiders dominated Boards that emphasized financial controls in evaluating and rewarding top management. These Boards increased the intensity of managerial efforts in maximizing short-term profits and they also avoided higher risk-return strategies that shareholders may prefer. According to Lin, Effective Monitor Theory argues that outsider-directors are motivated to protect shareholders’ interests and while doing so, they protect their reputation as experts in decision control.

Westphal suggested that close relations between CEOs and Board members tended to improve corporate performance through significant informal advice. In India as well as in the US, studies have linked larger corporate Boards to poor operating and stock-price performance. Large company Boards in India in the late ‘90s were slightly smaller than those in the US, with 9.46 members on average in India as compared to 11.45 in US. But, the percentage of inside directors was almost identical (25.38 per cent as compared to 26 per cent in the US), with relatively fewer Independent Directors (just over 54 per cent as compared to 60 per cent in the US) and relatively more affiliated.

* Non-Executive Directors.
outside directors (over 20 per cent versus 14 per cent in the US). Over 40 per cent of the
Indian companies also had a promoter on the Board and in over 30 per cent of the
companies, the promoter also served as the chair.

A review of above studies suggests that findings differ about outside directors as
monitors and the optimal mix of inside and outside directors might differ across
countries.

2.8.3 MULTIPLE DIRECTORSHIPS AND PERFORMANCE

Jayati Sarkar and Subrata Sarkar found that better and more efficient independent
directors are the ones with multiple appointments.\textsuperscript{161} These results are in consonance with
the \textit{resource-dependence perspective} i.e., directors with multiple appointments are
experienced, networked and knowledgeable. In case of inside directors, excessive
multiple directorships adversely impacts the company value.

2.8.4 NON-EXECUTIVE DIRECTORS AND PERFORMANCE

There is a positive association between the number of Non-Executive Directors
and firm performance.\textsuperscript{162}

2.8.5 INDEPENDENCE, ACTIVE REPRESENTATIONS AND EARNINGS

Xie \textit{et al.}, concluded that a management with a lower level of earnings is
associated with greater independent outside representations on the Board. Further,
management with a lower level of earnings is also associated with more active Boards
and more active Audit Committees.\textsuperscript{163}
2.8.6 BOARD AND COLLABORATIVE POLITICS

Simmers (1998) found that quality and speed of the strategic decision-making process by the Board and the outcomes were strongly related to collaborative politics. However, goal achievement was weakly associated with collaborative politics.\textsuperscript{164}

2.9 Audit Committee

2.9.1 AUDIT COMMITTEE AND FIRM PERFORMANCE

Al-Mudhaki and Joshi found that only 56.2 per cent of the firms had established an Audit Committee in their Board, despite the fact that it was already mandatory.\textsuperscript{165} Of those firms which have the Audit Committees, 68.3 per cent had between three to six members on the Audit Committees. Almost all the firms had Non-Executive Directors in the committees but only 14.6 per cent of firms had Independent Non-Executive Directors indicating a lack of independent representation on the committees. 58.5 per cent of firms in the sample stated that Audit Committee met monthly and 29.5 per cent firms stated that committee met quarterly. Internal control and evaluation function of an Audit Committee is very much influenced by the frequency of its meetings and an improvement in internal control will definitely improve the external financial reporting system especially in large companies. Hence, frequent meetings of Audit Committee may help in improving the CG practices. The authors suggest that the functions of Audit Committees are quite diverse and are classified into three categories i.e., financial statements and reporting, audit planning, and internal control and evaluation. Collier found that among the listed companies in UK, Audit Committees strengthened audit independence and public confidence in the integrity of the financial reporting.\textsuperscript{166}
2.9.2 ROLE OF AUDIT COMMITTEE IN CG

Varma and Dalal find that the members of the Board do not play their expected role and therefore, the existence of the Audit Committee may not guarantee good CG. Yet, Green considers an Audit Committee as an essential part of CG. Rutteman found that without regard for quality or effectiveness, the mere existence of an Audit Committee could be used as evidence that directors took due care in performing duties. Arthur Anderson’s survey of all listed companies in Australia found that 48 per cent of companies had formed Audit Committees, while Ernst and Young reported that the formation of an Audit Committee to carry out the financial reporting responsibilities of a Board has become a well established part of CG. Ernst and Young found that a majority of companies follow the Audit Committee practices in respect of adopting high-level Audit Committee charter, effective communication with the independent auditors, composition, reporting and meeting practices. Similarly, KPMG’s survey of 400 companies in Europe reported that more Audit Committees were established in the UK (100 per cent) than in the rest of Europe. Compared to companies in Europe, UK companies had adopted standard practices in terms of establishing a charter (100 per cent), composition (3 to 4 members), and meetings more than twice a year involving independent non-executive members of companies, whereas across Europe, 39 per cent of Audit Committees met only twice a year. In the Canadian context, Scarbrough et al., indicated that Audit Committees consisting of solely non-employee directors were more likely than Audit Committees with one or more insiders to (i) have frequent meetings with the Chief Internal Auditor, and (ii) to review the internal auditing program and results of internal auditing. Vicknair et al., examined the
percentage of affiliated directors on Audit Committees for one hundred New York Stock Exchange firms between 1980 to 1987. They found that more than one-quarter of all firms had Audit Committees with a majority of affiliated directors. Menon and Williams found that 156 firms from 200 National Association of Securities Dealers Automated Quotations firms had voluntarily formed Audit Committees. However, 19 (12 per cent) of the Audit Committees had at least one inside director. Further, 57 per cent of Audit Committees did not meet or only met once a year. Klein found a similar lack of independence in Audit Committees in a sample of Standard and Poor’s 500 firms, over a two-year period ending in 1993. Therefore, it is apparent that in the initial period of the formation of Audit Committees, firms tend to include insider-directors or directors from affiliated firms. This trend may not be different in developing countries like India. In another survey of Audit Committees, Price Waterhouse Coopers found that Audit Committees among European companies on an average met three to four times a year. Among the major European companies, 70 per cent of Audit Committees had three to four members. Porter and Gendall found that 61 per cent of both listed companies and significant public sector entities in New Zealand had Audit Committees that were expected to play a broader role in CG.

2.9.3 AUDITING, MANAGERIAL MONITORING, FIRM VALUATION AND CG

Jensen and Meckling contended that managerial ownership aligns the interests of managers and equity-holders and a positive relationship is expected between managerial ownership and firm valuation. Stulz developed a model of firm valuation in which the entrenchment effect results in a negative relationship between managerial ownership and
firm valuation at relatively high levels of managerial ownership. Other studies have also investigated this relationship. For example, Morck et al., and McConnell and Servaes found that their results supported both the positive alignment effect and the negative entrenchment effect. The empirical models, however, do not account for the monitoring effects associated with external auditing. Palmrose, Francis and Wilson and DeFond in the US found a lack of convincing evidence linking management ownership and leverage relevant to auditor choice. With a wide spectrum of governance mechanisms available to alleviate agency conflicts, the relative importance of external auditors is quite limited. According to Ghosh, in India, where conventional corporate control systems have begun to gain prominence only recently, it seems that independent external auditors could potentially act as important monitors controlling shareholders. Moreover, such monitoring may improve the value of firms. If this is true, then the major benefits derived from external auditing activity should be reflected in the higher capitalized value of the ownership claims on the corporation. According to Fan and Wong, recent empirical evidence for East Asian economies highlighted the fact that external auditors played a monitoring and bonding role in order to mitigate the agency conflicts between controlling owners and outside investors. According to Ganguli, in view of the changing business scenario a greater interaction or link between the auditors and the top echelon of management is needed.
2.10 Remuneration

2.10.1 REMUNERATION COMMITTEE AND FIRM PERFORMANCE

Narasimhan and Jaiswall found that in family-owned and controlled firms, the remuneration committee had a limited role to play on both pay-setting process and impacting performance through top management pay.186 They concluded that the remuneration committee plays an important role in mitigating the agency problem which is expected to be acute when family ownership is low or non-family members hold key positions. Moreover, management remuneration is determined on the basis of the financial accounting information. Also according to Bushman et al., half of the managerial bonuses are found to be determined by corporate performance reflected in the financial accounts.187 According to Klein, management has used accrual amounts to inflate the income in order to wangle hefty bonuses and salaries.188 Ezzamel and Watson found that among UK companies the characteristics of remuneration committee did not result in a strong relationship between pay and performance.189

2.10.2 EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE

Firms need to pay well to attract talent and yet, excessive pay to managers will reduce the residual earnings for investors. As CG gained momentum, researchers started focusing on the impact of various CG parameters on executive compensation. According to Jensen and Murphy, the level of pay affects the quality of managers.190 Bebchuk and Fried suggested that managers are in a position to decide their own pay and would do so in a way that would weaken the link between their pay and performance.191 Core et al., and Pukthuanthong et al., suggested that CG parameters like Board characteristics and ownership structures are major determinants of executive compensation.192 Ramaswamy
et al., found that firm performance was a significant explanatory variable in explaining CEO compensation. However, the family-ownership of a firm is found to be negatively related with CEO pay. According to the authors, this relationship could be because family ownership and management significantly reduce the agency problem. The study further reveals that CEO-Chairman duality and the proportion of insider directors has no relationship to executive compensation in family-owned firms. However, these factors are key variables in explaining compensation in non-family owned firms.

In the Indian context, Ghosh suggested that CEO remuneration has a positive influence on corporate performance judged in terms of accounting measures. Parthasarathy et al., found that the CEO compensation is not related to any of the profitability measures. On the other hand, the size of firm is a significant determinant of CEO compensation. The results also suggested that CEOs who were the promoters of their firms, received significantly more compensation than their ordinary counterparts. In addition, the study also indicated that CEOs of Public Sector Units are significantly underpaid compared to their counterparts in the private sector. According to Fagernas, roughly 300 firms each year reported that the average total compensation of Indian CEOs increased almost three-fold between 1998 and 2004 in real terms. During this period, the proportion of profit-based commission to total pay also rose steadily from 13.4 per cent to 25.6 per cent, and the percentage of CEOs with commission as a part of their pay package jumped from 34 per cent to 51 per cent. Further, executive compensation as a fraction of profit had almost doubled, from 0.55 per cent to 1.06 per cent. Interestingly, in the year 2000, the average US CEO compensation was 7.89 per cent of corporate profits for companies included in the 1500-Company ExecuComp Dataset. CEO pay has
become more performance-based over the past decade.\textsuperscript{198} Also increased performance-pay linkage has been influenced by the introduction of the CG Code. Fagernas also reports that CEOs or directors related to the founding-family were paid more than other CEOs.\textsuperscript{199}

Ghosh reported that during the period 1997-2002, the average Board compensation in India, based on a sample of 462 manufacturing firms, was around Rs. 5.3 Million with wide variation across firm size.\textsuperscript{200} The average Board compensation was Rs. 7.6 Million for large firms and Rs. 2.5 Million for small firms. Board compensation was also higher, on average at Rs. 6.9 Million, when the CEO was related to the founding-family. Since, almost two-thirds of the largest 500 Indian companies are group affiliated, issues of CG in firms owned by business groups become vital.

According to Jensen and Meckling and Fama, as per incentive constraint, aligning the incentive of the CEO with the shareholders is the easiest way to circumvent moral hazard on the part of the CEO.\textsuperscript{201} Thus, Hall and Liebman found a positive association between CEO compensation and financial performance.\textsuperscript{202} Mehran found that firms exhibiting a positive and significant relationship between CEO compensation and performance will provide higher returns to shareholders vis-a-vis companies where this relationship is less sensitive.\textsuperscript{203} According to Hall and Liebman and Main \textit{et al.}, when stock options were considered, a stronger pay-performance link could be identified.\textsuperscript{204} However, Ezzamel and Watson found that changes in executive pay were more closely related to external market comparison of pay levels than to change in either profit or shareholders wealth.\textsuperscript{205} In a poll by KPMG, around 85 per cent of the respondents think that remuneration of CEOs should be significantly linked to company performance.\textsuperscript{206}
According to Aggarwal and Samwick, executives’ pay-performance sensitivity for executives of firms with the least volatile stock prices was greater than firms with the most volatile stock prices.207

Core et al., found that firms with weaker governance structures had greater agency problems; the CEOs of such firms received a higher compensation and their performance was inferior.208 CEOs’ compensation was higher when the CEOs were also Board Chairmen and when Boards were larger with a greater percentage of outside directors appointed by the CEOs. Hermalin and Weisbach concluded that CEOs with interlocking Boards are paid more than otherwise similar CEOs and interlocking directorships provide the CEO with a degree of control over his Board that harms performance.209 According to Cyert et al., when stock holding by members of the compensation committee is large, such members are more involved in company affairs.210 Exhibit 2.1 presents the impact of Employee Stock Options and measures on performance.
## EXHIBIT 2.1

**EMPIRICAL ANALYSES OF IMPACT OF EMPLOYEE STOCK OPTION (ESO) AND MEASURES OF PERFORMANCE: A SELECTED CHRONOLOGY**

<table>
<thead>
<tr>
<th>Author(s), Year(s)</th>
<th>Nature of Sample, Year(s)</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lewellen, Huntsman (1970)</td>
<td>50 US companies, 1942-63</td>
<td>Including long-term elements has little effect on reward-performance link.</td>
</tr>
<tr>
<td>Cosh (1975)</td>
<td>1,601 UK companies, 1969-71</td>
<td>Size more important than profitability in determining narrowly defined pay.</td>
</tr>
<tr>
<td>Meeks, Whittington (1975)</td>
<td>1,008 UK companies, 1969-71</td>
<td>Sales the best determinant of pay, but profit’s significance reaffirmed.</td>
</tr>
<tr>
<td>Murphy (1985)</td>
<td>73 US companies, 1964-81</td>
<td>Performance more significant than size in explaining executive reward.</td>
</tr>
<tr>
<td>Abowd (1990)</td>
<td>16,000 managers in 250 US companies, 1981-6</td>
<td>Correlation between pay and degree of sensitivity between previous year’s pay and market performance.</td>
</tr>
<tr>
<td>Jensen, Murphy (1990)</td>
<td>1,688 executives, 1,049 US companies, 1974-86</td>
<td>Weak relationship between performance and remuneration. Incomplete ESO measure.</td>
</tr>
<tr>
<td>Conyon, Gregg (1994)</td>
<td>170 highest-paid UK directors, 1985-90</td>
<td>Sales growth significantly more important pay determinant than performance. No ESOs.</td>
</tr>
<tr>
<td>Main, Bruce, Buck (1994)</td>
<td>59 UK companies, aggregate Board, and highest-paid directors, 1982-9</td>
<td>Inclusion of ESOs significantly increases pay-performance link.</td>
</tr>
</tbody>
</table>

Source: Adapted from Bruce, Alistair and Trevor Buck, “Executive Reward and Corporate Governance,” in Kevin Keasey, Steve Thompson, and Mike Wright (Eds.), *Corporate Governance: Economic and Financial Issues*, Oxford University Press, New York, 1997, p. 94.
2.10.3 PERSONAL VARIABLES OF EXECUTIVES AND THEIR COMPENSATION

Only a few studies have focused on this research question. McKnight *et al.*, examined the impact of CEOs’ age on executive pay in UK from 1992 to 1996 and found a significant relationship between CEOs’ age and salary.\(^{211}\) However, according to Veliyath and Ramaswamy, no significant impact of CEOs’ personal characteristics on their pay was found.\(^{212}\) Ghosh found the personal characteristics of the CEOs such as age and education ineffective in explaining CEOs’ compensation.\(^ {213}\) However, he found in-firm experience of CEOs and their relationships with the promoter of the firm and group as the most important determinants of CEOs’ compensation. Grunditz and Lindquist investigated 65 listed companies in Sweden and concluded that there was no significant effect of CEOs’ age on their bonus.\(^ {214}\) A study in UK by McKnight and Tomkins, revealed no significant relationship between tenure and CEO compensation (salary + bonus) from 1992 to 1997.\(^ {215}\) Hijazi and Bhatti analyzed the determinants of executive compensation of 63 executives from 54 different organizations in Pakistan and revealed that work experience and education level of CEOs were positively and significantly related with the executive compensation.\(^ {216}\) Kang, and Payal found that age, qualification, tenure and experience of executive directors are not significant determinants of executive compensation.\(^ {217}\) The foregoing review of literature reveals that there is no clear-cut relationship between the personal characteristics of the executives and their remuneration.
2.11 Separation of Chief Executive Officer and Chairman

Matteo Tonello concluded that companies which had ‘split’ the roles of Chairman and CEO increased Board’s independence from management and it led to better monitoring and oversight. However, Baliga et al., found weak evidence on the link between duality of Board Chairman and CEO and long-term performance of US companies.

2.12 Institutional Investors

2.12.1 INSTITUTIONAL INVESTORS, CORPORATE PERFORMANCE AND OTHER IMPLICATIONS

The basic objective of an institutional investor is to maximize its own shareholders' wealth and not to monitor the activities of the companies in which it has invested. In consonance with the above view, Admati, Pfleiderer and Zechner, Black, Coffee, and Monks argued that absence of appropriate incentives and the free rider problem hinder institutional activism.

Khanna and Palepu and Varma infer that institutional investors in India have played a passive role in CG. Similarly, Sarkar and Sarkar observed that the Development Financial Institutions (DFIs) play a passive role in CG when their combined holding is less than 25 per cent. However, the authors found that when the debt exposures of the DFIs are high, they play an active role in monitoring the performance of the companies. It is more cost effective for institutional investors to

* Free rider problem means if one institutional investor intervenes in the decisions (CG) of a company, the other investors also get the benefits but at a cost solely to the institutional investor and hence this discourages active intervention the by institutional investors.
remain passive without taking the trouble to acquire information to exercise voting rights meaningfully. Mohanty found that in India, the short-term performance measures of the fund managers force them to become very short-term oriented. Charkham divides the institutional investors into two categories i.e., Type-A and Type-B. Type-A institutions have a portfolio of a very small number of companies but their stake in each individual company is very large. Type-B institutions, on the other hand, manage a widely diversified portfolio. Hence, CG fails as most institutions fall in Type-B because only the Type-A institutional investors have an incentive for active monitoring as it affects their portfolio value substantially. Cordtz argues that the institutional investors lack the expertise and ability to serve as effective monitors. However, Shleifer and Vishny observed that institutional investors, by virtue of their large stockholdings would have greater incentives to monitor corporate performance as they derive greater benefits of monitoring.

Ajinkya, Bhojraj, and Sengupta found a positive relationship between financial analysts’ ratings of corporate disclosure practices with institutional stock ownership. Brickley, Lease, and Smith found that institutional investors are more likely to vote against harmful amendments that reduce shareholders’ wealth. Agarwal and Mandelkar found a positive relationship between institutional ownership and shareholders wealth. McConnell and Servaes found a positive relationship between institutional ownership and productivity.

However, Holderness and Sheehan, and Denis and Denis found no evidence about any relationship between institutional holdings and CG. Black concludes that American institutional shareholder activism had no effect on firm performance.
study by California Public Employees Retirement System (CalPERS) concluded that many corporate assets are poorly managed and that resources spent on identifying and rectifying these assets can create substantial opportunity and premium returns for active shareholders. Moreover, a steep erosion of shareholder value, on a cumulative basis, involving 142 companies, essentially stopped after the Public Employees Retirement System became involved. Karpoff and Romano concluded that shareholder activism results in small changes in some firms’ governance structures. However, the evidence as a whole does not suggest that shareholder activism leads to improvement in firm performance or value. According to Shleifer and Vishny, large investors represent their own interests, which need not coincide with the interests of other investors in the firm, or with the interests of employees and managers. Short and Keasey found that in the absence of other large external shareholders, institutional investors had a significant positive effect on firm performance. According to Agrawal and Knoeber, no significant relationship was found between performance and institutional stockholding. Del and Hawkins, Gillan and Starks, John and Klein and Karpoff, Malatesta and Walkling observed that institutional activism had negligible impact on the performance of the companies. Daily et al., studied 13 US activist funds and their holdings in 197 large companies and found that institutional activism had no appreciable effect on firm performance and stock price.

In the Indian context, Sarkar and Sarkar suggested that lending institutions start monitoring the firm effectively only after equity holdings cross a substantial limit. Besides this, the monitoring process is reinforced by the extent of debt exposures of these institutions. Further, the study found that foreign equity ownership has a beneficial effect
on company value. Mohanty also corroborated these findings. He found that development financial institutions have lent money to firms with better CG measures. Besides, mutual funds have also invested money in firms with a better CG record. He concluded that investment by mutual funds and development financial institutions has improved the financial performance of companies. Patibandla also broadly presents similar conclusions, though using a different methodology. Further, he found that the increasing presence of foreign institutional investors proved to be having a positive effect on corporate performance. Ali Khan was also of the view that domestic institutional investors do not really help in improving performance of the firms. The author indicated that the nominee directors are concerned only about safeguarding their institutional interest in the companies rather than protecting all shareholders. Further, the nominee directors do not play a satisfactory role in the Board meetings i.e., in contributing to better management practices and effective functioning of the firm. Besides, the role of institutional investors, such as mutual funds and pension funds is not active. In this context, a working group on CG stated that “the institutional investors of public companies should see themselves as owners and not as investors”. The Kumar Mangalam Birla Committee on CG emphasized that “that the institutional shareholders put to good use their voting power”.

2.13 Stakeholders, Corporate Social Responsibility and Performance

Crowther argued that the emergence of the World Wide Web has facilitated the dissemination of information and exerted more pressure on companies as business is accountable to stakeholders. Ogden and Watson found considerable improvement in
the customer service since the privatization of UK water supply industry in 1989 and higher returns to shareholders, consistent with the *Stakeholder Theory.* Crowther revealed that firms with good financial performance are also good at social responsibility. Hence, social responsibility and shareholder value creation appear to be related.

According to Verschoor, 26.8 per cent of the 500 largest US corporations with a commitment to ethical behaviour in forms of social and ethical accounting, auditing and reporting in the annual reports had a higher overall financial performance than those which did not assume explicit undertakings. According to Coffey and Wang, Boards with more inside directors had shown more support for corporate philanthropic behaviour than diverse Board having more outsiders.

2.14 Disclosures

2.14.1 FIRM PERFORMANCE, VALUATIONS, DISCLOSURES AND OTHER IMPLICATIONS

Over the last two decades, more precisely after the *Cadbury Committee Report* UK, transparency and disclosures about companies have become paramount. Transparency is crucial to stakeholders as it is the principal norm by which companies can be held more accountable. According to Solomon and Solomon, disclosures can be viewed from two perspectives – corporate disclosure and financial accounting disclosure.

Montgomery and Kaufman identified CG disclosures as the link between management and the shareholders and hence disclosures are also a part of CG. According to Healy and Palepu, disclosures have many more objectives other than being
a CG mechanism. The topic of disclosures is one of the oldest research streams in finance.

According to Diamond and Verrecchia, and Kim and Verrecchia, previous research had reported that investors evince interest in relevant and reliable disclosure of a company’s performance. According to Kothari, Bushman and Smith, regulated disclosure provides new and relevant information for investors which ultimately reflects transparency.

Financial accounting information has been given more importance by the Cadbury Committee Report UK, but, later on, it was realized that financial accounting information represents only one aspect of corporate disclosure. According to Healy and Palepu, disclosure comprises all forms of voluntary corporate communications. For example, management forecasts, some information placed on websites of companies and other statements and reports such as value added statements, funds flow statement, analysis of strengths, weaknesses, opportunities and threats, and corporate social responsibility or social accounting of companies also constitute disclosures. According to Chahine and Filatotchev, disclosure indicates the quality of the firm’s product and business model, its growth strategy and market positioning, as well as the risk element. According to the Cadbury Committee Report better disclosure results in more transparency, which is vital for good CG. According to Jensen and Meckling, improved disclosure reduces agency cost, which is the bone of contention between the principal and the agent. Farrar and Hannigan stated that when better information flows from the company to the shareholders, it results in less information asymmetry and hence improved disclosures. According to Healy and Palepu, the importance of disclosure can be observed from the
perspective of Agency Theory because the contract between principal and agent requires the agent to disclose relevant information which enables the principal to monitor the agent’s compliance with the contractual agreement. Further, Healy and Palepu, point out that disclosure of information enables the shareholders to know the efficiency of management and status of returns to investors. Lang and Lundholm found that firms which had more disclosures, have a larger pool of potential investors leading to improved market capitalization. These investors had more accurate beliefs about the future performance of firms. Collet and Hrasky have revealed that the voluntary disclosure of corporate information is positively associated with raising equity capital but not with debt capital. Chahine and Filatotchev concluded that too much disclosure of propriety information may lead investors to believe that such disclosure may harm the firm’s value. Chandler opined that companies are sometimes reluctant to disclose information which could tarnish their image, as for instance, the salary of the employees at the lower level and higher level in the hierarchy.

There has been ample research which documents the positive relationship between disclosure and firm performance. Lang and Lundholm had reported that analysts’ ratings of corporate disclosure are positively related to earnings. Similarly, Botosan concluded that increased disclosures create benefits for companies. Further, disclosure policies were found to have a positive effect on the cost of capital but not on stock market liquidity. Moreover, Healy et al., using a sample of US, companies found that after controlling for earnings performance and other potential relevant variables such as risk, growth and firm size, expanded voluntary disclosure is associated with an increase in stock performance, growth in institutional ownership, increased stock
liquidity and higher analysts’ coverage. Healy and Palepu had reported that firms have incentives to engage in voluntary disclosure in order to reduce information asymmetry. Therefore, it reduces the cost of external financing through reduced information risk and hence leads to better performance. Bushman and Smith had reported that financial accounting information can affect the investments, productivity and value-addition of firms. Khanna et al., found a positive relationship between capitalization and the overall transparency scores. They concluded that past performance can also affect the degree of disclosure. For instance, profitable firms may be more willing to disclose information to outside investors compared with less profitable firms. Hence, the findings do not indicate the causal relationship between disclosure and a firm’s performance. It is not clear from the studies as to which causes what, between disclosure and firm’s performance. Increased enforcement of accounting standards through auditing, and increased disclosure may improve earnings transparency. CalPERS’ approach to improving portfolio returns by engaging management of poorly performing companies to rethink governance and strategy continues to work. Despite underperforming their respective benchmarks by 83.3 per cent for the five years up to the initiation of CalPERS’ shareholder activism, the 142 companies that were targeted from 1987 to the fall of 2008 have outperformed by 12.7 per cent over the subsequent five-year period. A McKinsey study had shown that global investors are willing to pay more for better governed companies. Simultaneously, better CG also helps to reduce bribery practices at the firm level, which can potentially further increase the value of firms. Kohli concludes that better CG leads to value creation for all the stakeholders.
Two cross-country studies in the year 2003 have put India among the worst nations in terms of earnings opacity and management.\textsuperscript{281} Accounting Standards in India provide companies considerable flexibility in financial reporting and these standards differ from International Accounting Standards or International Financial Reporting Standards in numerous ways. Hence, interpreting Indian financial statements is relatively challenging.

A few studies have highlighted the negative relationship between corporate disclosure and firm-level performance. Archambault and Archambault had documented an inconsistent relationship between firm’s size as measured by total assets and total disclosure score.\textsuperscript{282} However, according to Holder-Webb \textit{et al.,} large firms have richer information environments and they are also exposed to more political costs.\textsuperscript{283} According to Cheung \textit{et al.,} large firms have more resources to undertake additional CG initiatives as they are well known to the investing public and they are expected to disclose more information.\textsuperscript{284} Based on observations of the Securities and Exchange Board of India from a consolidated compliance report prepared by Bombay Stock Exchange and National Stock Exchange in 2003, the compliance level with respect to requirements related to the remuneration committee and Board procedures is low or not satisfactory and the compliance related to Board of Directors, audit committee and shareholders’ grievance committee is high.\textsuperscript{285} So companies should enhance their standards in terms of disclosures to sustain their revenues and profits internationally. Gupta \textit{et al.,} studied 30 Indian companies listed on the Bombay Stock Exchange and indicated that though the firms have provided information related to all the dimensions, there was considerable variance in the extent and quality of such disclosures.\textsuperscript{286} In Australia, Ramsay and Hoad
found that the extent and quality of disclosures are typically better for larger companies than for smaller ones.\textsuperscript{287} Brown and Caylor in US, considered internal and external CG factors and found that Gov-Score\textsuperscript{∗} was significantly and positively associated with firm valuation (using Tobin’s Q).\textsuperscript{288}

Arcot and Bruno examined the effectiveness of the ‘comply or explain’ approach to CG in the UK and found increased compliance with the combined code and simultaneously a frequent use of standard and uninformative explanations by the firms when departing from best practices.\textsuperscript{289} This smacks of compliance in letter but not in spirit. Bhuiyan and Biswas examined CG practices in Bangladesh and computed a Corporate Governance Disclosure (CGD) Index and found a significant difference among the CGD indices of various sectors.\textsuperscript{290} Financial sector firms engaged in more intensive CG disclosures than non-financial sector firms. In general, companies were found to be more active in making financial disclosures rather than non-financial disclosures. CGD Index was significantly influenced by local ownership, notification of the Securities Exchange Commission (of Bangladesh) and the size of the company. Irrespective of whether a financial or non-financial institution, the size of the Board of Directors was not found to have any significant impact on CG disclosures. According to Holder-Webb \textit{et al.}, smaller firms offered fewer disclosures pertaining to Board independence, Board selection procedures, and oversight of management.\textsuperscript{291} The Boards that were less independent provided fewer disclosures on independence and management oversight matters; whereas, large firms provided more disclosures of independence standards, Board selection procedures, audit committee matters, management control systems, other

\textsuperscript{∗} Broad summary measure of Corporate Governance.
committee matters and whistle-blowing procedures. Yet, their information environment was not found to be better than smaller firms. Javed and Iqbal indicated that CG does matter in Pakistan.\textsuperscript{292} Board composition, ownership and shareholding pattern were found to enhance firm performance, whereas disclosure and transparency had no significant effect on firm performance. According to Gill and Sai, there is no unambiguous answer to the relationship between the CG disclosures and a firm's performance, though the literature on corporate disclosures provides substantial support.\textsuperscript{293}

### 2.14.2 INDEPENDENT DIRECTORS AND DISCLOSURES

Chen and Jaggi found a positive correlation between the proportion of Independent Directors on corporate Boards and comprehensiveness of financial disclosures.\textsuperscript{294} However, this association is weaker for family-controlled firms compared to non-family controlled firms.

### 2.15 Other Committees

#### 2.15.1 NOMINATION COMMITTEE FOR NOMINATING BOARD MEMBERS AND CORPORATE PERFORMANCE

According to Wallace and Cravens, large public companies in the US with a nomination committee displayed both a market and accounting-quantified performance better than companies without such a committee.\textsuperscript{295}

#### 2.15.2 OVERSIGHT BOARD COMMITTEE AND FIRM VALUE

Klein found no apparent correlation between share prices and the composition of specific oversight Board committees.\textsuperscript{296}
2.16 Miscellaneous

2.16.1 LEGAL PROTECTION AND DIVIDEND

Faccio et al., held that strong legal protection leads to higher dividend payouts.\textsuperscript{297}

2.16.2 DEBT, PERFORMANCE AND CG

According to Berger et al., entrenched CEOs avoided debt financing and leverage levels declined when the CEOs were longer in office and did not face pressure from either ownership and compensation incentives or active monitoring of the Board.\textsuperscript{298} According to Agrawal and Knoeber, more debt financing was negatively related to performance.\textsuperscript{299}

2.16.3 THE MARKET FOR CORPORATE CONTROL AND CG

According to Chakrabarti et al., a freely functioning market for corporate control is another important force for more effective governance that has failed to emerge in India.\textsuperscript{300} Though Indian regulators were resistant to hostile acquisitions earlier, it is now more open.\textsuperscript{301} At present the market for corporate control in India is not limited by geography and therefore it has improved prospects for CG.

2.16.4 PRIVATIZATION, PROFITABILITY AND CG

A study by Nandini Gupta of 47 partial privatizations found that despite government control, privatization has had positive effects on the profitability, productivity and investment of the privatized Public Sector Enterprises.\textsuperscript{302} Hence, privatization can promote good CG.
2.17 Impact of Internationalization

Sanders and Carpenter found that most of the large firms in the US coped with the information processing demands and agency issues arising from internationalization through larger Boards, thereby acquiring greater expertise across functions and geographical areas. Apart from this, other practices in the aforesaid corporate environment include higher longer-term CEO pay as a recognition of more challenging jobs, aligning CEO self-interest with corporate performance, separation of the chairperson and CEO positions and more inside directors with multiple interactions between the Board and company.

The foregoing review of the literature reveals that though the value of CG has received much wider attention worldwide, more research is required, especially in India.
REFERENCES


15 ibid.


19 Shleifer and Vishny, op. cit., p. 771.


22 ibid.


24 ibid.


26 FAQs on Corporate Governance, www.nseindia.com


2009, p. 15.


Gill et al., op. cit., p. 16.


74 La Porta et al. (1999b) cited by Phani, et al., op. cit., p. 5.


Phani, et al., op. cit., p. 5.

77 Bertrand et al., cited by Chakrabarti, et al., op. cit., p. 71.


Findings of a three-member committee constituted by Ministry of Finance on the Current State of Corporate Governance in India, op. cit., pp. 69-70.


112 Chugh, Lal C., Joseph W. Meador and Ashwini Shanth Kumar, “Corporate Governance and Firm Performance: Evidence from India,” *Journal of Finance and Accountancy*, p. 5, available at http://www.google.com/cse?cx=016995616770396476863%3A9vdxrwh2xpw&ie=UTF-8&q=Lal+Chugh+C&siteurl=www-open-opensocial.googleusercontent.com%2Fgadgets%2Fifr%3Furl%3Dhttp%253A%252F%252Fwww.google.com%252Fcse%252Fapi%252F016995616770396476863%252Fcse%252F9vdxrwh2xpw%252Fgadget%26container%3DOpen%26view%3Dhome%26lang%3Dall%26country%3DALL%26debug%3D0&ref=aabri.com%2Fsearch.html#gsc.tab=0&gsc.q=Lal%20Chugh%20C&gsc.page=1 website accessed on 5.4.2012, 1.50 a.m.


118 Chendroyaperumal, op. cit., p. 39.


129 Barney cited by Gill et al., op. cit., p. 10.


Van, et al., cited by Gill et al., op. cit., p. 11.


Garg, op. cit., p. 58.


Perry and Shivdasani cited by Gill *et al.*, op. cit., p. 11.


Chugh *et al.*, op. cit., p. 5.


Westphal, J. D. (1999), “Friendly Boards are Not All Bad,” *Business Week*, 14 June, 34, cited by Chi-Kun, Ho, “Corporate Governance and Corporate Competitiveness:


Arthur, Anderson (1992), Audit Committees for the 1990s, June; Ernst and Young (1990), A New Focus for the Audit Committee, Toronto: Ernst and Young, December, cited by Al-Mudhaki and Joshi, op. cit., p. 36.


Independence: Evidence from the NYSE on Grey Area Directors,” *Accounting Horizons*, 7(March), pp. 53–57 cited by Al-Mudhaki and Joshi, op. cit., p. 36.


197 Bebchuk and Fried, cited by Chakrabarti et al., op. cit., p. 70.

198 ibid.

199 Fagernas, cited by Chakrabarti et al., op. cit., p. 70.


204 Hall, B. J. and Liebman J. B. (1997), “Are CEOs Really Paid Like Bureaucrats?,” Harvard Institute of Economic Research, Paper No. 1789; Main, B., Bruce, A. and


Crowther, D. (2002c), *A Social Critique of Corporate Reporting*; Aldershot; Ashgate


Chahine and Filatotchev cited by Gill *et al.,* op. cit., p. 13.


ibid, p. 14.


278 “CalPERS Effect” on Targeted Company Share Prices, 2009, op. cit.


280 Kohli, op. cit., p. 53.


2010, p. 81.


293 Gill *et al.*, op. cit., p. 17.


300 Chakrabarti et al., op. cit., p. 71.

