CHAPTER I

INTRODUCTION

Capital market reforms, increasing inflow of foreign capital, increasing number of institutional investors and multi-national corporations are changing the Indian business environment at global level. The process of Globalisation had thrown open many opportunities. With the increased inflow of foreign direct investment in many sectors of the Indian economy, Indian business would not be able to avoid the rigour of international regulations. Hence, International business is borderless and competitiveness is dictating success in the economic growth of a nation.

Globalisation of business, unprecedented competition and rapid technological changes have combined to squeeze margins, shorten product life cycles and to greatly heighten business risks. With the arrival of many major foreign investors in India, the international investors would insist that companies in which they have interest should follow a 'code of corporate governance'. In such a situation Indian businesses cannot afford to disregard the best practices of corporate governance since India is a developing nation.

Globalisation may be defined as the integration and unification of the national economies into the world economic system. It operates mainly through the market forces and dominated by western technology, capital goods, product designs
and management techniques. These unifying and integrating market operations are embodied in an international economic order that manifests itself through the processes of international trade and financial transactions, including international investment. Globalisation and liberalisation have led to the entry of the multinational corporations and the foreign institutional investors in India. Indian companies have spread their activities across national borders. These factors have led to increased competition. This environmental change has led to changes in the earnings, dividends and the market prices of equity shares.

The term corporate governance has emerged on the Indian scene recently. To most observers of Indian corporate scene, there appears to be very little in India by way of meaningful corporate governance. During the last few years, the need for improvement in corporate governance has received considerable attention in India. Concept of corporate governance in its true sense has still not been fully evolved. Good corporate governance is the key to ensure that the competitiveness of the Indian industry is maintained and further strengthened.

The takeover boom, entry of multinational corporations and foreign institutional investors after the announcement of new economic policy had brought the concept of corporate governance to prominence. A revolution was mounted against the power complexes of corporate headquarters. The recent mergers, acquisitions and other leveraged restructuring constitute an assault on the entrenched authority that was long overdue.
Corporate governance is a part of corporate ethics and value system. Corporate governance can be defined from several angles. It is not capable of being precisely defined. Corporate governance can be defined as a system of structuring, operating and controlling a company with the specific aim of fulfilling the long-term strategic goal of the owners.

Cadbury committee\(^1\) presented a report on financial aspects of corporate governance in December 1992. It formulated the rules and procedures to enhance the effectiveness of the board. It emphasised the need to maximize the shareholders value by a good corporate governance system. Consequently, Greenbury committee\(^2\) was appointed to bring out the best practices in determining and accounting for directors' remuneration. All listed companies registered in United Kingdom comply with the code to the fullest extent practicable and include a statement about their compliance in the annual reports to shareholders by their remuneration committees. Any areas of non-compliance should be explained and justified. The Cadbury committee report has formed the basis for a debate on code of corporate governance in India. The report hence has drawn a worldwide attention.

The organisation for Economic Co-operation and Development (OECD)\(^3\) in its ministerial level meeting on 27-28 April, 1998 had established an ad-hoc task force on corporate governance with an objective to develop a set of non-binding

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2 Greenbury Committee, Recommendations on Corporate Governance.
principles that embody the views of member countries on corporate governance. The principles contained in the report were: 1. Protection of shareholders’ rights 2. the role of stakeholders 3. Need for disclosures and transparency and 4. responsibility of the board for better corporate governance. In September 1999, the World Bank\(^4\) published a report on corporate governance and presented a framework for implementation. It has observed that globalisation would bring uniformity in corporate governance system.

The confederation of Indian Industry’s (CII)\(^5\) Desirable Corporate Governance is the first major functional exercise on corporate governance in Indian Industry. It is expected that the code for corporate governance be followed uniformly by Indian companies in private and public sectors. The code of governance is applicable to banks and financial institutions also. The code of governance emphasizes protection of investors’ interest and developing high level of confidence in business and industry. There are 17 recommendations to be followed by companies in reporting corporate governance. It also emphasizes the global concerns about the objectives of ‘good’ corporate governance: maximizing long-term shareholders’ value.

Consequent to the CII publication on code of corporate governance, Indian companies have started reporting details of future investments, expansion,

\(^3\) Organization for Economic Corporation & Development (Europe), OECD Principles of Corporate Governance, April 1998.


diversification plans, intellectual capital valuation, brand value, economic value added, financial ratios etc. The recent annual reports of companies contained a report on corporate governance. Economic value added signifies the effort of the company towards reporting shareholder enrichment. Quantifiable measures like economic value added and market value added have started appearing in annual reports. Disclosure of these information provide shareholders an understanding of the direction in which a company is moving. Recognising the importance of good corporate governance the Indian Companies Act has also been modified to provide considerable importance to the role of board of directors in corporate governance.

Consequent to the appointment of Kumaramangalam Birla committee\(^6\) to draft the report on corporate governance, a draft report was submitted to The Securities and Exchange Board of India (SEBI) recently. It agreed that the fundamental objective of corporate governance is the enhancement of the long-term shareholder value, while at the same time protecting the interests of other stakeholders. It set out a time limit for implementing the recommendations.

\(^6\) The Associated Chambers of Commerce and Industry of India. Corporate Governance.
The Associated Chambers of Commerce and Industry of India has also published a report on corporate governance. It emphasised that care should be taken in appointing directors, particularly in listed companies for better corporate governance.

The above reports emphasise the importance of a code of good corporate governance for Indian corporate sector. These concepts also led to the emergence of code of governance in Government and code of Electronic governance due to the introduction of electronic commerce in India.

1.1 STATEMENT OF THE PROBLEM

At present in India there is a common debate to explore a model, which can be relevant to corporate environment in the country. A new paradigm for corporate governance that is in tune with the changing trends is the demand for greater accountability of companies to their shareholders and customers. A country’s economy depends on the drive and efficiency of its corporate sector. Companies are collective institutions of people, with diverse interests, but pursuing towards a common objective of growth and development of every individual. A system of good corporate governance is to work within a framework of effective accountability.

Of several aspects of corporate governance, financial aspects of corporate governance are the most important because the ultimate objective of a business is

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to maximise the wealth of the shareholders. The increasingly institution dominated and performance driven investors are putting enormous pressure on corporate management for delivering unfailing financial performance. Good corporate governance leads to the growth in sales, profits, assets and market value of shares. Overall growth leads to the growth in shareholders' wealth. From financial Institutions point of view, corporate governance is a philosophy by which owners and managers are expected to be perennially responsive to other entities such as shareholders, promoters, institutional shareholders, deposit holders, creditors, consumers and finally to institutional lenders.

Financial accountability has gained momentum at a time when investor and public confidence have been shaken in all but a few of the 8000 odd listed companies in India. For listed companies, surplus generation and wealth creation process translates into value creation for all the shareholders as reflected in the long-term growth in market price of shares. The importance of delivering shareholder value can be seen from the fact that nearly 25 to 30 percent of the companies (about 2500) listed on the Indian stock exchanges were quoting at a fraction of their issue price and many are quoting as low as a rupee. This has wiped out investors' wealth, more importantly their confidence in the performance of companies.

The dominant players are the financial institutions. The public on an average is the second largest equity holders in companies. The third and fourth are the promoters and foreign institutional investors respectively. A vital element of corporate governance lies in the management, which is answerable to the
shareholders as to the custody and conduct of company's business activities and the commercial exploitation and preservation of assets. Corporate governance is a concern of great importance to shareholders because shareholders' wealth depends in large part up on the goals the people who set the strategy of the company. All the reports on corporate governance have emphasized that the basic objective of a corporation is to maximize shareholder value. Hence it is generally considered that the sole responsibility of any business is to its shareholders and the business is expected to maximize the value of the shareholders.

The above points emphasize the necessity to carry out a comprehensive study to investigate the recent changes in corporate governance practices, corporate growth and shareholder enrichment in India. There were many studies conducted in U.S.A, U.K. and other advanced countries. Even though, there are many theoretical studies available in India, no comprehensive empirical research has been undertaken in India on corporate governance, growth and shareholders enrichment. What had happened in India so far in this sphere was seminars, workshops, conferences and articles on corporate governance in various journals in India. These sources have certainly created an awareness of good corporate governance.

1.2 OBJECTIVES OF THE STUDY

There have been quite a few studies conducted in India on corporate governance. Most of the studies were concentrated on board of directors, corporate ownership, legal compliance, accounting and social responsibility of corporations.
Of all the aspects of corporate governance, financial performance aspect is very important because the ultimate objective of any business is to maximize the wealth of the shareholders.

As it has been pointed out earlier that a separate and distinct studies on corporate governance and shareholder enrichment are scanty, there is a need for a comprehensive study on corporate governance, corporate growth and its impact on shareholder enrichment. The present study is thus an attempt in this direction. The overall objective of the study is thus to analyze the concept of corporate governance in India.

The following are the specific objectives of the present study.

1. To examine and analyze the recent trends in corporate governance practices in India;
2. To evaluate the behaviour of selected performance variables and to measure their growth rates;
3. To measure the impact of corporate governance on corporate growth and shareholder enrichment; and
4. To analyze the inter-relationship between corporate governance, corporate growth and shareholder enrichment.
1.3 METHODOLOGY

In order to have a fruitful study it has been decided to select a sample of 100 companies taking into account the time availability and cost involved in collecting data. In order to have a better structure for the survey of literature materials were collected from leading libraries in Chennai such as British Council, Madras University and Institute for Financial Management and Research. The researcher has also utilised library resources available at Indian Institute of Management, Bangalore and Calcutta. Besides leading journals, published and unpublished reports and seminar papers have been scrutinised for related materials and approach. The study relies mainly on secondary data collected from various sources. The sources include Annual Reports of the sample companies, database available with capital market publications and Centre for Monitoring Indian Economy (CMIE).

The present study is both descriptive and analytical in nature. Important analytical tools have been used attempting to evaluate the present status of Corporate Insurance in India and the need for good corporate governance in the context of privatisation, liberalisation and globalisation policies of the Government of India.

1.4 SAMPLE DESIGN

A sample of one hundred companies whose shares are actively traded in Bombay Stock Exchange and National Stock Exchange were considered for the study. The following criteria were used for selecting the sample companies:
1. The data for all the five years considered were available;
2. The payments of dividends were made more or less continuously;
3. The number of share holders were sufficiently large in number; and
4. The shares are actively traded in Bombay Stock Exchange and National Stock Exchange.

The list of companies included in the sample with abbreviations is given in appendix.

1.5 PERIOD OF STUDY

The study covers a period of 5 years ranging from 1993 to 1997. This period has witnessed phenomenal changes in the corporate sector due to the implementation of new economic policy of the Government of India.

1.6 DATA AND SOURCES OF DATA

The data collected for the present study are mainly secondary in nature. The data collected for the study are information relating to the assets, earnings, dividends, sales etc. of the selected companies. Data were collected from the annual reports, reports of the Reserve Bank of India, stock exchanges, department of company affairs and other published sources.
**Data Structure**

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Symbol</th>
<th>Column</th>
<th>Description</th>
<th>Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sales Per Share</td>
<td>SALPS</td>
<td>10</td>
<td>Gross Fixed Assets Per Share</td>
<td>GFAPS</td>
</tr>
<tr>
<td>2</td>
<td>Profit Before Interest and Tax Per Share</td>
<td>PBITPS</td>
<td>11</td>
<td>Net Fixed Assets Per Share</td>
<td>NFAPS</td>
</tr>
<tr>
<td>3</td>
<td>Profit Before Tax Per Share</td>
<td>PBTPS</td>
<td>12</td>
<td>Long Term Loan Per Share</td>
<td>LTLPS</td>
</tr>
<tr>
<td>4</td>
<td>Profit After Interest and Tax Per Share</td>
<td>PAITPS</td>
<td>13</td>
<td>Net Worth Per Share</td>
<td>NWORPS</td>
</tr>
<tr>
<td>5</td>
<td>Cash Profit Per Share</td>
<td>CPPS</td>
<td>14</td>
<td>Total Funds Employed Per Share</td>
<td>TFE:MPPS</td>
</tr>
<tr>
<td>6</td>
<td>Earnings Per Share</td>
<td>EPS</td>
<td>15</td>
<td>Market Price Per Share</td>
<td>MPS</td>
</tr>
<tr>
<td>7</td>
<td>Dividend Per Share</td>
<td>DPS</td>
<td>16</td>
<td>Economic Value Added Per Share</td>
<td>EVA</td>
</tr>
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<td>8</td>
<td>Retained Earnings Per Share</td>
<td>REPS</td>
<td>17</td>
<td>Market Value Added Per Share</td>
<td>MVA</td>
</tr>
<tr>
<td>9</td>
<td>Reserves and Surplus Per Share</td>
<td>R&amp;SPS</td>
<td>18</td>
<td>Total Shareholders’ Return</td>
<td>TSR</td>
</tr>
</tbody>
</table>

The data collected for the sample companies were adjusted to facilitate comparison and analysis. Data were collected on various items of assets, sales, earnings, dividends and market price of shares. Necessary adjustments have been made for uniformity and comparison.

The face value of shares for the sample companies ranges between Rs. 5 and Rs. 125. The shares of a majority of the companies are of the face value of Rs.10. To facilitate comparison the data were adjusted to a face value of Rs. 10 per share. For example, if a company’s face value of the share is Rs. 100, it has
been converted into 10 shares of Rs. 10 each. The values of all the variables are expressed for a face value of Rs.10 per share.

1.7 ANALYSIS OF DATA

Frame work of analysis

As the secondary data collected for the sample companies have been expressed in quantitative form, it has facilitated the use of the statistical tools of analysis for drawing inferences. The statistical tools thus used to analyze the data, includes summary statistical measures, which are used to describe the behaviour of selected variables. The important measures calculated in summary statistics are averages, standard deviation, standard error, range, skewness and kurtosis.

Besides, frequency distribution gives an idea about the nature of the distribution of data. Raw data will not give any idea, but when it is arranged in a frequency distribution it will give a better idea about the nature of the data such as lowest and highest value and the classes in which values are concentrated. Hence frequency distribution for various variables for the sample companies are constructed in this study.

In addition, to study about the relationship among earnings per share, dividend per share, retained earnings per share and market price per share etc., the simple correlation analysis has been used. The value of correlation co-efficient ‘r’ ranges from −1 to +1. The sign indicates the direction at which the variables are related. The magnitude measures the strength of the relationship. If ‘r’ = 0, the
variables are assumed to be not correlated, which implies the absence of linear dependence of one on the other. If ‘r’ = +1 there is perfect positive relationship between them, which implies if one variable increases (decrease) the other will also increase (decrease) at the same rate. If ‘r’ = -1, there is perfect negative relationship between them, which implies if one variable increases (decreases) the other will decrease (increase) at the same rate.

Multiple Regression analysis has also been used to evaluate the impact of changes in earnings per share, dividend per share, retained earnings per share etc on market price per share. Simple growth rates of all selected variables were also computed and used in the study.

1.8 TERMS USED IN THIS STUDY

1) **Sales Per Share (SALPS)**

SALPS = Net sales / Number of shares

2) **Profit before Interest and taxes per share (PBITPS)**

PBITPS = Profit before interest and taxes / Number of shares

3) **Profit before Taxes per share (PBTPS)**

PBTPS = (Profit before interest and taxes − interest) / Number of shares
4) Profit After Interest and Taxes per share (PAITPS)

PAITPS = (Profit before interest and taxes - (Interest + tax)) / Number of shares

5) Cash Profit Per Share (CPPS)

CPPS = Cash Profit / Number of shares

6) Earning per share (EPS)

Earning per share (EPS) shows the amount of earnings available to equity shareholders. The amount of EPS has been arrived at as below.

EPS = (Earnings After Interest and tax - Preference dividend) / Number of Equity Shares

7) Dividend Per Share (DPS)

Dividend per share shows the amount of dividend paid per share. The amount has been arrived at as below:

DPS = Total dividends paid / Number of equity shares

8) Retained Earnings per Share (REPS)

After making payment of dividends, the residual left over out of the earnings per share is called retained earnings and is computed as follows

REPS = Earnings Per Share - Dividend Per Share
Whenever the amount of earnings per share is negative, indicating loss, retained earnings per share also shows a negative value. This indicates no amount has been retained since there is no earnings. In such case retained earnings per share has been taken as zero in the analysis.

9) **Reserves and Surplus Per Share (R&SPS)**
   
   \[ R&SPS = \frac{\text{Reserves and surplus}}{\text{Number of shares}} \]

10) **Gross Fixed Assets Per Share (GFAPS)**
   
   \[ GFAPS = \frac{\text{Gross Fixed Assets}}{\text{Number of shares}} \]

11) **Net Fixed Assets Per Share (NFAPS)**
   
   \[ NFAPS = \frac{\text{Net Fixed Assets}}{\text{Number of shares}} \]

12) **Long Term Loans Per Share (LTLPS)**
   
   \[ LTLPS = \frac{\text{Long Term Loans}}{\text{Number of shares}} \]

13) **Net Worth Per Share (NWORPS)**
   
   \[ NWORPS = \frac{\text{Net Worth}}{\text{Number of shares}} \]

14) **Total Funds Employed Per Share (TFEMPPS)**
   
   \[ TFEMPPS = \frac{\text{Total Funds Employed}}{\text{Number of shares}} \]

15) **Market Price Per Share (MPS)**
   
   The value of market price per share has been computed by taking into account the annual high and low values of the market price of share. The average value of this is taken as the market price per share.

   \[ MPS = \frac{(\text{High} + \text{Low Market Price Per Share})}{2} \]
16) Economic Value Added (EVA)

Modern thinkers have developed tools that enable us to ascertain whether shareholders' value has been created or destroyed over time. The three principal tools in this direction are Market value added, Total shareholder return and Economic value added. Economic value added measures the profitability of a company after taking into account the cost of all capital including equity. It is the post-tax return on capital employed minus the cost of capital employed.

If economic value added is positive the business has generated wealth in excess of what is expected by the shareholders and vice versa. If the figure for a particular year drops below zero, it indicates that expectations of the shareholders are not being met. The usefulness of economic value added is that it can be applied to various divisions of a company to improve its efficiency.

\[
\text{Economic value added} = \text{Net operating profit after tax per share} - \text{cost of capital}
\]

17) Cost of Capital

Cost of capital has been computed by assuming a return of 20% on capital employed. The following formula was used for computing the Cost of capital.

\[
\text{Cost of capital} = \frac{\text{Capital employed}}{100} \times 20
\]
18) **Capital Employed per Share**

Capital employed per share is a sum of net worth and long term borrowing i.e. **excluding** short-term borrowing such as cash credit from banks and commercial papers.

\[
\text{Capital employed} = \text{face value per share} + \text{reserves and surplus per share} + \text{long term loans per share}
\]

19) **Net Operating Profit after Tax per Share**

Net operating profits after tax per share was computed by adding Net operating profit after tax plus interest divided by number of shares.

\[
\text{Net operating profit after tax per share} = \frac{(\text{Net operating profit after tax} + \text{interest})}{\text{Number of shares}}
\]

20) **Market Value Added (MVA)**

The calculation of MVA enables one to conclude whether the company has been valued by the market in excess of its total funds. In instances where this is so, the assumption is that the market is willing to place a premium on the company's value in recognition of its future earnings potential.

\[
\text{Market value added} = \text{Economic market value added} - \text{Economic book value added}
\]

\[
\text{Economic market value added} = \text{Market price per share} + \text{Long term loans per share} + \text{Reserves and surplus per share}
\]
Economic book value added = Face value per share + Long term loans per share + Reserves and surplus per share

21) Total Shareholders Returns (TSR)

Since dividends and the expansion in market capitalization are the two principal ways in which shareholders can be enriched, total shareholders return takes into account the sum of these two factors. The increase in market capitalization is added to the dividend paid out by the company during the financial year. This sum is then expressed as a percentage of the market capitalization of the company at the start of the financial year under review.

Total shareholders return was computed as given below:

$$\text{TSR} = \frac{((\text{MPS}_t + \text{DPS}_t) - \text{MPS}_{t-1})}{\text{MPS}_{t-1}}$$

- $\text{MPS}_t$ = Market price per share - current year
- $\text{DPS}_t$ = Dividends per share - current year
- $\text{MPS}_{t-1}$ = Market price per share - previous year
- $\text{MPS}_{t-1}$ = Dividends per share - previous year

1.9 LIMITATIONS OF THE STUDY

Since the new economic policy was introduced during 1991 the data were collected for five years from 1992-93 to 1996-97. Even though, there are several aspects of corporate governance, corporate growth and shareholder enrichment have been accorded top priority. As the field of registered companies in India is
geographically wide, large and complex, the scholar keeping the academic principle in mind has restricted the number of companies only to 100.

The companies selected are large and actively traded companies only. The study mainly depends on secondary data collected from the published sources. As such general limitations applicable to this method of data collection will apply to this study also. However enough care has been taken to ensure reliability and adequacy of data to fulfill the objectives of the study.

1.10 ARRANGEMENT OF CHAPTERS

The study is organized into six chapters.

The first chapter deals with need and importance of the study, objectives, data and sources of data, period covered, analysis of data, sample design, methodology and limitations of the study.

The next chapter is devoted to a detailed discussion of theoretical aspects of corporate governance and corporate growth in India. It also includes review of related literature.

The third chapter deals with the trends in corporate governance in India. A detailed analysis of various international and Indian reports on corporate governance are portrayed. It contains reports of Cadbury committee, Greenbury committee, Organization for Economic Cooperation and Development, World Bank, Confederation of Indian Industry, Securities and Exchanges Board of India and Associated Chamber of Commerce and Industry.
An analysis of corporate governance and shareholder enrichment is presented in the fourth chapter. It contains the summary statistical analysis and frequency tabulation analysis of selected variables. Association among selected variables and stepwise multiple regression analysis have also been presented in this chapter.

The fifth chapter deals with an analysis of growth rates in selected variables. Various measures of shareholder enrichment are discussed. Summary statistical measures and frequency tabulation analysis of growth rates are presented in this chapter.

The last chapter presents a summary of findings and general conclusions.