CHAPTER – I

INTRODUCTION
1. **Chapter 1: Introduction .................................................................1 – 15

1.1 Prologue ............................................................................................1

1.2 A Brief Introduction to Corporate Governance ..............................1

1.3 Brief Introduction to Pharmaceutical Industry ...............................2

1.4 Review of Literature ........................................................................3

1.5 Research Gap ....................................................................................4

1.6 Statement of the Problem ..................................................................5

1.7 Need for the Study ...........................................................................5

1.8 Research Questions ...........................................................................6

1.9 Objectives of the Study .................................................................7

1.10 Research Hypotheses .....................................................................8

1.11 Scope of the Study .........................................................................10

1.12 Research Methodology ..................................................................10

1.13 Thesis Design ...............................................................................13

1.14 Limitations of the Study ...............................................................15

1.15 Scope for Further Research .........................................................15
1.1 Prologue

“Corporate Governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholder’s role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place”.

The Cadbury Committee on Corporate Governance, 1992

Management of a company has become complex due to its inherent nature of dispersed ownership, separation of ownership from management, organizational structure, and widespread activities. Corporate governance is the way of corporate life. And the roles of governance participants like shareholder representatives (directors) and management are crucial to ensure smooth functioning of an organization. On the other hand, entrepreneurs and management of companies are faced with a challenge to accomplish economic and social motives collectively. With the occurrence of corporations’ failure in upholding the trusteeship principle, there arose a need for improving transparency and accountability of companies. There exists a daunting challenge to the regulators to keep away corporate frauds and protect the interests of shareholders and stakeholders. Because, a fraud like Satyam can have serious economic as well as social implications on various groups. Public companies in an emerging country like India, are suffering from conflicts of interest between principals and agents and also between controlling shareholders and minor shareholders. Though there are a number of regulatory mechanisms to ensure better governance, still misconducts of companies and people associated with them are being reported. Internal governance mechanisms play prominent role in deciding the state of corporate governance in a firm. And it ultimately decides the fate of the firm. The aim of this study is to examine the status of governance practices in pharmaceutical industry in India.

1.2 A Brief Introduction to Corporate Governance

Governance put in simple words, means administering laws that guide decision making and controlling acts of rulers. Hence, corporate governance refers to

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the way a corporation is administered or governed. It means carrying business in the best interest of various stakeholders in general and shareholders in particular.

As defined in the **Clause 49 of the listing agreement**, corporate governance is “A set of systems, processes, and principles which ensure that a company is governed in the best interest of all stakeholders.”

Shareholders of a joint stock company are widely scattered across a country and the globe, and find it difficult to run and manage their business. So, they elect a group of individuals, among themselves (usually promoters), called board of Directors to oversee and monitor the management of the company by appointing executives to look after day-to-day affairs of the business. BOD decides the direction in which firm should move. Shareholders, Board of Directors and Management are the three important participants in corporate governance mechanism. The other stakeholders include suppliers, customers, employees, government, and other regulatory agencies and public at large. Corporate governance concerns about how the agents of shareholders create and sustain long term value acting for the good of different stakeholders. It is all about balancing individual, economic, as well as societal goals.

It is right of the owners (shareholders) and indeed of the other stakeholders to expect a fair and transparent dealing on part of the directors and managers. And the owners must ensure proper use and safety of their investments and also the actual performance of agents (BOD and Management) should be in accordance with the standards. These dimensions of corporate governance should not be overlooked. A system of good corporate governance ensures transparent, strong, and balanced economic development of a nation.

### 1.3 A Brief Introduction to Pharmaceutical Industry

Pharmaceutical industry is one of the leading and growing industries in India and is at the top of other science based industries. Pharmaceutical industry in India comes under the regulation of Department of Pharmaceuticals under the Ministry of Chemicals & Fertilizers, Government of India. This industry plays a major role in determining economic growth of our nation. India is one of the five emerging pharmaceutical markets in the world.

According to a report of the Department of Pharmaceuticals, the domestic Pharma Industry has achieved some historic milestones through a leadership position
and global presence as a world class cost effective generic drugs’ manufacturer of AIDS medicines (2014-15, p.11)\(^2\). Department also reports that the Indian pharmaceutical companies maintain highest standards of international health, safety, and environmental protection and supply of bulk drugs.

There are about 10,000 pharmaceutical manufacturers across the country (NPPA, 2007)\(^3\). Maharashtra, Gujarat, West Bengal, Andhra Pradesh, and Tamil Nadu states have 63.60% of manufacturing units situated in these five states. This industry, not only determines the economic condition of a nation, but also the quality of health of the people and their life expectancy. Pharmaceutical industry in India provides quality medicines ranging from a small generic drug to sophisticated antibiotic drugs for major diseases. It meets about 70% of domestic demand for bulk drugs, chemicals, drug intermediates, tablets, orals, pharmaceutical formulations, and injectables.

Severe competition due to increased demand from within and also from different parts of the world, strict market regulation, price control system, patent rights etc., are major challenges encountered by pharmaceutical industry in India. Moreover, some pharmaceutical companies (For example, Ranbaxy Laboratories, GVC Bliss Pharma) were in news recently because of poor quality of medicines manufactured by them and breaking the regulatory standards of Food and Drug Authorities of other countries. An ex-employee of Ranbaxy Laboratories has accused Ranbaxy company of using fraudulent data for getting US FDA’s approval for selling its generic drugs. It is surprising to know that, reputed pharma companies like Ranbaxy’s 30 generic drugs manufactured in two plants in India are banned in US. However, this industry has been successful in overcoming such challenges and even attracting potential players and existing companies are also incorporating new technologies, methods and models into their businesses.

1.4 Review of Literature

The strength of any research depends on the foundation laid down on past studies. They give a proper base for finding the gap in concerned area and help to derive the objectives of present study. This section of review of literature gives us a


brief description of past studies that are reviewed till now. Literature collected for the study includes journal articles, working papers of various institutions, dissertations, theses, newspaper publications, and books relating to different dimensions of the study. Nearly 200 literatures were collected and reviewed which encompass studies from India and other different countries worldwide and includes studies from the time of corporate governance reforms during early 2000 to recent year 2016. They have been classified based on different dimensions of the study such as Ownership, board of directors, CEO-Chairman role duality, other internal governance mechanisms, Regulatory standards, CG practices, firm performance, Pharmaceutical industry, and other dimensions of governance. Within each classification, the studies have been ordered chronologically. Chapter 2 deals with Literature Review.

1.5 Research Gap

The review of literature helped the researcher to arrive at the gap. Majority of the studies on corporate governance practices are in the form of articles. And they relate to various sectors and very few studies are particularly identified with pharmaceutical industry. This work pursues a study of corporate governance practices in pharmaceutical industry and tries to bridge the gap identified.

The present study concentrates on the evaluation of relationship between ownership structure and board composition and the duality of chairman and CEO roles which in turn may impact the firm performance. Further, the study examines the extent of disclosure compliance with mandatory and non-mandatory recommendations of clause 49 of the listing agreement among selected pharmaceutical companies. The guidelines of clause 49 of the listing agreement include different aspects of governance, but it is difficult to say that all companies comply with all guidelines in true spirit. It is evident from earlier studies that corporate governance reporting practices are not standardized and there are differences in reporting practices. Further, only few companies, which have advocated the significance of a good governance system, have been complying with non-mandatory recommendations of clause 49 voluntarily.

Thus, the present study encompasses three facets. Firstly, it studies the existing internal governance practices followed in pharmaceutical companies in India. Secondly, it includes study of disclosure compliance with clause 49 of the listing
agreement, and thirdly, the examination of the relationship between internal governance practices and their relationship with firm performance measures.

1.6 Statement of the Problem

The governance practices of public companies have a vital influence on administration, management, performance, and also protection of shareholders and stakeholders interests. Internal practices such as ownership, boards, committees, disclosures etc. which are controllable, are major players in this regard. However, ownership of Indian companies is dominated by promoters and promoter groups. Few cases such as Satyam showed the involvement of promoter directors and senior executives in corporate frauds. There also found improper disclosure of governance practices and deviation from regulatory standards. Thus, the state of internal governance practices, regulatory compliance, and the influence of ownership on them in public companies are crucial factors that draw public attention.

1.7 Need for the Study

The board members and management play a crucial role as agents of shareholders in the governance system of firms. Indian governance system is characterized with controlling ownership (usually promoters and family), interlocking directorship, cross holdings etc. Moreover, the duality of roles of chairman of the board and Chief Executive Officer can be seen in most of the Indian companies. It is evident from the earlier studies that, the concentrated ownership, independent board, and CEO-chairman role duality have mixed results on firms’ performance. As Indian companies are featured with concentrated ownership, the impact of such concentrated ownership on board independence, committees’ composition, CEO-chairman role separation, and firms’ performance and also the fair disclosure is also an important aspect which requires detailed study.

Pharmaceutical industry has been chosen as study area, as it is a major contributor to the economic development of India with 8-9% annual growth rate and is also a major foreign exchange earner. And recently some of the pharmaceutical companies have been in news due to poor drug quality and non-adherence to regulatory norms of respective countries, which ultimately points at flaws in governance system present in those firms. Though extensive research and studies on corporate governance issues in India and around the world in various other sectors are
available, governance issues of Drugs and Pharmaceutical industry are not much covered.

Hence, in the context of the above situation and considering the vital role played by pharmaceutical industry in India, the present study tried to answer the questions; “What is the state of internal governance system and their disclosure in the industry?” , “How does ownership structure and other governance mechanisms interact with each other and how they influence firm performance?”

1.8 Research Questions

Based on the literature reviewed, following research questions have been framed that are addressed in the study. Though these questions can be generalized to whole of the corporate sector, the present study concentrates specifically on selected pharmaceutical companies listed in India.

1. What is the shareholding pattern in pharmaceutical firms in India?
2. What is the composition of board of directors (i.e., total no. of directors, no. of executive, non-executive, and independent directors) in selected pharmaceutical companies?
3. What are the major committees constituted in each company and what are their compositions?
4. Whether selected companies have combined the roles of chairman and CEO?
5. Is there any relationship between ownership pattern and board composition attributes?
6. What is the effect of ownership pattern on independence of audit committee?
7. Does ownership pattern influence the duality of board chairman and CEO roles?
8. Do the selected pharmaceutical companies comply fully with clause 49 of the listing agreement?
9. Is there any difference among companies’ disclosure practices in corporate governance reports?
10. What is the level of compliance with non-mandatory recommendations of clause 49 of the listing agreement among selected companies?
11. Is financial performance of a selected pharmaceutical company influenced by the company’s ownership pattern?
12. Is there any relationship between a company’s board composition and its financial performance?
13. What is the relationship between each committee’s composition and firm’s financial performance?
14. What is the impact of CEO-chairman role separation on companies’ financial performance in selected pharmaceutical companies?

1.9 Objectives of the Study

The present study of ‘Corporate governance practices of Pharmaceutical industry in India’ is primarily based on following objectives.

1. To study the existing internal governance practices of pharmaceutical industry.
2. To assess the level of corporate governance disclosure practices in compliance with Clause 49 of the listing agreement among selected pharmaceutical firms.
3. To examine the relationship between ownership pattern and board composition.
4. To analyze the relationship between ownership pattern and audit committee independence.
5. To study the relationship between ownership pattern and audit committee meetings.
6. To evaluate the relationship between ownership pattern and CEO-Chairman role duality.
7. To analyze the relationship between ownership pattern and ROA, ROE, EPS and Tobin’s Q.
8. To examine the impact of board composition on ROA, ROE, EPS and Tobin’s Q.
9. To understand the impact of audit committee composition on ROA, ROE, EPS and Tobin’s Q.
10. To evaluate the relationship between remuneration committee composition and ROA, ROE, EPS and Tobin’s Q.
11. To analyze the relationship between shareholder grievance committee composition and ROA, ROE, EPS and Tobin’s Q.
12. To study the impact of CEO and chairman role duality on ROA, ROE, EPS and Tobin’s Q.
13. To analyze the level of disclosure practices among large cap, mid cap and small cap companies.

1.10 Research Hypotheses

Following null hypotheses have been formulated on the basis of literature review and study objectives, and will be tested. The hypotheses are grouped under related objective.

Hypotheses relating to objective 3

\[ H_01 \] : “There is no significant relationship between promoter shareholdings and total number of directors in the board”

\[ H_02 \] : “There is no significant relationship between non-promoter shareholdings and total number of directors in the board”

\[ H_03 \] : “There is no significant relationship between promoter shareholdings and number of independent directors in the board”

\[ H_04 \] : “There is no significant relationship between non-promoter shareholdings and number of independent directors in the board”

\[ H_05 \] : “There is no significant relationship between promoter shareholdings and number of executive directors in the board”

\[ H_06 \] : “There is no significant relationship between non-promoter shareholdings and number of executive directors in the board”

\[ H_07 \] : “There is no significant relationship between promoter shareholdings and number of board meetings”

\[ H_08 \] : “There is no significant relationship between non-promoter shareholdings and number of board meetings”

Hypotheses relating to objective 4

\[ H_09 \] : “There is no significant relationship between promoter shareholdings and number of independent directors in audit committees”

\[ H_{010} \] : “There is no significant relationship between non-promoter shareholdings and number of independent directors in audit committee”
Hypotheses relating to objective 5

H\textsubscript{011} : “There is no significant relationship between promoter shareholdings and number of audit committee meetings”

H\textsubscript{012} : “There is no significant relationship between non-promoter shareholdings and number of audit committee meetings”

Hypotheses relating to objective 6

H\textsubscript{013} : “There is no significant relationship between promoter shareholdings and CEO-chairman role duality”

H\textsubscript{014} : “There is no significant relationship between non-promoter shareholdings and CEO-Chairman role duality”

Hypothesis relating to objective 7

H\textsubscript{015} : “There is no relationship between ownership pattern and ROA, ROE, EPS & Tobin’s Q”

Hypothesis relating to objective 8

H\textsubscript{016} : “There is no relationship between board composition and ROA, ROE, EPS & Tobin’s Q”

Hypothesis relating to objective 9

H\textsubscript{017} : “There is no relationship between audit committee composition and ROA, ROE, EPS & Tobin’s Q”

Hypothesis relating to objective 10

H\textsubscript{018} : “There is no relationship between remuneration committee composition and ROA, ROE, EPS & Tobin’s Q”

Hypothesis relating to objective 11

H\textsubscript{019} : “There is no relationship between shareholder grievance committee composition and ROA, ROE, EPS & Tobin’s Q”

Hypothesis relating to objective 12

H\textsubscript{020} : “There is no relationship between CEO-Chairman role duality and ROA, ROE, EPS & Tobin’s Q”
Hypothesis relating to objective 13

$H_0^{21}$ : “There is no significant difference in disclosure practices of large cap, mid-cap and small cap companies”

1.11 Scope of the Study

This work is related to the study of corporate governance practices in selected pharmaceutical companies listed in the Bombay Stock Exchange and the National Stock Exchange. The study describes the internal governance practices followed in companies such as ownership pattern, board composition, audit, remuneration and shareholders grievance committees’ composition, and CEO-chairman role duality. On the other hand, it analyses the inter-relationship between above said governance practices and also their impact on companies’ financial performances.

The study is carried out in selected 71 listed pharmaceutical companies. This sample is arrived at based on their market capitalization. Some companies are registered outside India and they are only operational within India. Such companies are also taken as they are also obligated to comply with SEBI listing rules.

1.12 Research Methodology

This section includes explanation about population, sampling method, sources of data, data collection procedure and data presentation and analysis tools.

1.12.1 Population:

Bombay Stock Exchange website was visited for sampling purpose. The population includes all companies, whose securities are listed in pharmaceutical sector under equity segment with active status as on 10th May, 2016. Many of these companies are listed in National Stock Exchange also. Hence, the final sample includes companies listed only in Bombay Stock Exchange or both in Bombay Stock Exchange and National Stock Exchange.

The list (appendix) shows the sampling frame of companies with their market capitalization. This list excludes companies not listed in pharmaceutical sector and the companies which were not traded as on the day when information was collected.

The study classifies the population into three categories viz. large cap, mid-cap and small cap companies on the basis of market capitalization of individual
companies. The following table gives statistics of total population classified on the basis of market capitalization.

Table 1.1:

<table>
<thead>
<tr>
<th>Company segment</th>
<th>No.</th>
<th>Percentage</th>
<th>MC (Rs in Cr.)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Small Cap’ (MC* ≤ Rs. 1000 Cr.)</td>
<td>100</td>
<td>70.92</td>
<td>13,561.88</td>
<td>1.81</td>
</tr>
<tr>
<td>2. Mid Cap’ (MC Rs. 1001 Cr. – Rs. 10000 Cr.)</td>
<td>23</td>
<td>16.31</td>
<td>84,193.57</td>
<td>11.26</td>
</tr>
<tr>
<td>3. Large Cap’ (MC More than Rs. 10000 Cr.)</td>
<td>18</td>
<td>12.77</td>
<td>6,49,856.79</td>
<td>86.93</td>
</tr>
<tr>
<td>Total</td>
<td>41</td>
<td>100</td>
<td>7,47,612.24</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Compiled data

MC* = Market Capitalization

Fig. 1.1: Bar Graph showing number and market capitalization of small, mid and large cap sample companies in percentage

The above table gives the classification of pharmaceutical companies based on their market capitalization together with total market capitalization in each segment and their percentage contribution to total capitalization. The number of small cap companies is 100 out of total 141 companies. This segment constitutes the major part of the population in terms of numbers with 70.92%, followed by mid cap companies
with 16.31% (23 in no.) and 18 large cap companies with 12.77%. However, small cap companies hold a very low proportion of total market capitalization though they are majority in number. Conversely, large cap companies form the major portion (86.93%) of market capitalization though being very less in numbers. And mid cap companies hold 11.26% of market capitalization.

1.12.2 Sampling Method:

The study selects samples out of total population as classified above, in each segment. Simple random sampling method is used. 50% companies from each classification are randomly chosen. Hence, the final sample is constituted by 50 small cap (50% of 100 companies), 12 mid cap (50% of 23), and 9 large cap (50% of 18 companies) companies. The final sample size is 71 companies representing all three segments of the companies.

**Fig. 1.2:**

**Derivation of sample size**

- Small Cap Companies (100) 50%
- Mid Cap Companies (23) 50%
- Large Cap Companies (18) 50%
- Final sample- 71 companies (50+12+9)

1.12.3 Requisite conditions to be fulfilled for selecting the sample:

1. Companies from pharmaceutical sector
2. Companies whose securities are listed in equity segment as on 10\textsuperscript{th} May, 2016
3. Companies with active status as on 10\textsuperscript{th} May, 2016
4. Companies should have been traded as on 10\textsuperscript{th} May, 2016

1.12.4 Sources of Data:

Annual reports of selected pharmaceutical companies are collected from company websites and other repositories in order to collect data relating to ownership structure, composition of the board and its committees, CEO-chairman role duality
and to check the level of compliance with clause 49 of the listing agreement. Other published reports and circulars of companies and regulatory authorities are also the sources of secondary data.

1.12.5 Data Analysis and statistical tools applied:

• **Checklist for corporate governance disclosure level**: A corporate governance checklist is constructed showing mandatory and non-mandatory recommendations of Clause 49. Scores are assigned for the items of the checklist based on the disclosure of particular items in the corporate governance section of the annual reports for each year. Score 1 is given for companies following the item through disclosure and 0 otherwise. These scores facilitate the items ranking based on disclosures and to evaluate the comparative governance practices between large cap, mid cap and small cap companies.

• **Descriptive statistics**: Mean, standard deviations, median, minimum, and maximum are used for showing statistics of overall corporate governance disclosure scores and statistics of other internal governance variables.

• **Spearman rank correlation**: Spearman rank-order correlation is used to test the relationship between two variables. It assesses the monotonic relationship between two variables.

• **Multivariate regression analysis**: This tool is used where there is more than one predictor variable.

• **ANOVA**: Used to compare the internal governance variables and disclosure practices among three segments of the sample companies.

1.13 Thesis Design

Plan of the thesis is as follows:

**Chapter 1- Introduction**

An introduction to the study is given by discussing briefly about corporate governance concepts, pharmaceutical industry, need for the study and statement of the problem, objectives and hypotheses of the study and methodology used. It also lists the research questions that resulted after an in depth review of previous studies. It also comprises the limitations of the study.
Chapter 2- Review of Literature

It gives an extensive coverage of literatures reviewed. The previous studies include theses, dissertations, journal articles, books, periodicals, published reports of various regulatory authorities and institutes, across different time periods and across different countries of the world. All studies have been classified based on their place of origin and have been arranged chronologically.

Chapter 3- Corporate Governance: Conception, History, and Developments

This chapter introduces the readers about the concept of corporate governance, its development across the globe and also in India. It largely deals with the origin and development of corporate governance reforms in India and the present status.

Chapter 4- Bird View of Clause 49 of the Listing Agreement

Chapter 4 gives a detailed analysis of Clause 49 of the listing agreement and its importance. This clause is a benchmark against which corporate governance practices of sample companies have been compared with.

Chapter 5- A Profile of Pharmaceutical Industry

The details about the profile of pharmaceutical industry, its history, growth, present state and future prospects are presented in chapter 5. The process used in pharmaceutical companies, introduction to various terminologies etc, It includes the import and export statistics of pharmaceutical industry in India.

Chapter 6- Data Analysis and Interpretation

Chapter 6 gives a detailed picture of statistical analysis of data. It includes descriptive statistics of internal governance practices, item wise disclosure scores for five years and tools used for testing each hypothesis, tabular depiction of analysis results, inference drawn there on.

Chapter 7- Summary of Findings

It lists and discusses all major findings relating to internal governance practices, disclosure practices, comparative analysis, and hypotheses testing. And chapter is concluded by a brief summary.
Chapter 8- Suggestions and Conclusion

The last and final chapter of the thesis suggests the companies and regulators based on study findings. And lastly it concludes the research.

1.14 Limitations of the Study

1. Time factor is a major constraint for a longitudinal study like this that requires more time for data gathering, coding, data entry, and analysis.
2. This study is entirely based on secondary sources of data like annual reports as it considers clause 49 provisions as benchmark.
3. The study is limited only to pharmaceutical sector companies listed in the Bombay stock exchange and the National stock exchange.

1.15 Scope for Further Research

1. Survey of directors, executives, and employees’ views on corporate governance practices followed in their firms can be a potential area for further research.
2. A study of comparative corporate governance practices among different sectors can be taken up.
3. Study of corporate governance practices after enactment of the Companies Act, 2013 and revision of clause 49 would be a prospective scope for further research.
4. A comparative study of corporate governance practices between pre-revision and post-revision periods to clause 49 can be taken up.