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A STUDY ON THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE

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Abstract

The Cadbury Report defines Corporate Governance as the "system by which businesses are directed and controlled" (Cadbury, 1992). Corporate governance refers to generally accepted norms, customs, laws, habits and regulations determining the manner of running the company. Though concrete evidence does not substantiate the relationship between good corporate governance and creation of value for an organization, there is strong evidence in the past to affirm the destruction of good values by bad corporate governance. This descriptive research endeavours to establish the relationship between financial performance of firms and corporate governance of 30 Indian companies, listed on the BSE. Data pertaining to Return on Assets and Corporate Governance variables of Board Size (number of directors in board), Duality (if chairman and managing director are same), Remuneration to the board of directors, independence (Number of non-executive directors) and Board Ownership (Shareholding pattern of promoter and promoter's group) of these companies have been collected for the five year period of 01/04/2009 to 31/03/2014 from moneycontrol.com and CMIE data source and analysed using SPSS, employing the statistical tools of correlation, regression and Mean. Results reveal that the two Corporate Governance variables of Board Ownership and Duality are exerting a significant impact on ROA at 5% level.

Keywords:

Board Composition, Board Ownership, Corporate Governance, Duality, Return on Assets

1. INTRODUCTION

Corporate Governance caught the attention of researchers during 1998 with the Confederation of Indian Industry publishing the desirable voluntary code. SEBI made headway in the field of Corporate Governance by formulating the first ever formal regulatory framework for listed companies on corporate governance on February 2000 under Clause 49 of the Listing Agreements. These regulations were framed based on the suggestions of Kumar Mangalam Birla Committee Report, 1999. These regulations were amended on October 2004 based on the proposals of Narayana Murthy Committee Report, 2003. Very recently, the Ministry of Corporate Affairs formulated guidelines on corporate governance for voluntary adoption by the corporate sector on December 2009. The latest revised Companies Act of 2013 has got provisions relating to Corporate Social Responsibility to be adhered to by corporates.

Corporate Governance encompasses monitoring and market processes, establishing the relationships between the owners of a company and its management, board and other stakeholders and the targets towards which the company is marching.

Though concrete evidence does not substantiate the relationship between good corporate governance and creation of value for an organization, there is strong evidence in the past to affirm the destruction of good values by bad corporate governance. This was strongly demonstrated by the Satyam Scandal in India during 2008 -09 and instances in the corporate world such as Enron, WorldCom, etc. Hence, weak corporate governance is a red signal which has to be carefully monitored by all stakeholders of corporates as well as the government regulatory bodies.

The Cadbury Report defines Corporate Governance as the "system by which businesses are directed and controlled" (Cadbury, 1992). corporate governance refers to generally accepted norms, customs, laws, habits and regulations determining the manner of running the company. To put it on a comprehensive perspective, corporate governance comprises of all efforts to maximize the value of owners of a company without compromising the interests of other stakeholders of the company such as Government, employees, suppliers, customers, competitors, investors and the society. Corporate governance assumes significance in the corporate world as there is a disparity between the owners and managers of a company and this necessitates fair degree of transparency in the managing of affairs of companies to secure trust and buoyancy of all stakeholders. Managers of companies should act as good trustees for assets of the company.

Though corporate governance has been a popular concept in the developed countries, globalization and liberalization has made the topic gain rapid popularity in India and other developing countries of late. Opening up of the Indian economy has thrown open many opportunities and challenges for the domestic firms. They have to confront extensive competition both from domestic and multinational corporates and corporate governance has become a critical factor for them to gain competitive advantage, thereby ensuring their survival.

2. PRINCIPLES OF CORPORATE GOVERNANCE

Since Corporate Governance serves the common interests of numerous stakeholders and many studies have established its significant impact on performance of firms, they have to understand the principles of Corporate Governance and strategy to be implemented to uplift their Corporate Governance standards. The generally accepted principles of Corporate

Governance are Transparency, Accountability, Responsibility and Fairness.

3. REVIEW OF LITERATURE

Neelam Bharadwaj and Batani Rahavendra Rao (2014) have found that majority of companies studied are merely complying to mandatory requirements and disclose information required by the revised clause 49 while few companies such as Bajaj auto, Infosys, Dr. Reddy, etc. are disclosing information beyond the mandatory levels as required by clause 49.

Jatinder Kaur (2014) has found that various committees constituted under the corporate governance mechanism plays a vital role in enhancing the performance and competitiveness of banking companies and acts as a clear path for achieving business excellence.

Abayay Raja and Hitesh shah (2014) found that the two variables of duality and presence of block holders significantly impact financial performance while all other variables of corporate governance exert insignificant impact on financial performance.

Jia Hua Tsai et al. (2013) pointed out that intellectual capital is significantly linked with stock return characteristics and professional manager control of firms. Resource and development intensity, Advertising intensity and Human resource capital intensity are significantly related to Tobin's Q.

Priyanka Aggarwal (2013) established that corporate governance rating exerts positive impact on financial performance of firms. The study revealed that good governance fosters better financial performance and that ratings of company along with employees related and environmental dimensions also significantly influence corporate financial performance.

Pallavi Kapooria et al. (2013) found that Inclusion of Directors' Remuneration in Annual Report of a company significantly affect performance of companies of IT and Manufacturing sectors. Such a disclosure of remuneration instills confidence in the minds of shareholders, thus enhancing image and overall performance of the company. Hence, the study concludes that among the different recommended norms of corporate governance, disclosure plays a predominant role in enhancing firm's image and hence its performance.

Amarjit Gill et al. (2012) have recognized the positive relationship between investment decision of small business firms and their CEO tenure, CEO duality, board size, total assets and firm performance. In the case of small firms belonging to service industry, investment decision of the firms is positively related to their CEO duality, total assets and firm performance while in the case of firms belonging to manufacturing industry, investment decision is positively related to board size and firm performance.

Zhe Zhang et al. (2011) have established that CEO duality is negatively related with customer satisfaction while a separate leadership structure increases customer satisfaction.

Ajay Kumar Garg (2007) found evidence for better performance of smaller boards than the larger ones. The study also revealed that the ideal board size is six while board size and firm's performance are inversely related. The study also revealed that independent directors have failed to perform their monitoring role effectively and improve the performance of the firm.

4. OBJECTIVES OF THE STUDY

1) To assess the prevalence of relationship between corporate governance and financial performance of 30 companies, listed in BSE
2) To assess the impact of Corporate Governance on the Performance of these companies.

5. METHODOLOGY

The proposed research is descriptive in nature, based exclusively on secondary data, collected from moneycontrol.com and CMIE data source. Data pertaining to corporate governance variables of Board Size (number of directors in board), Duality (if chairman and managing director are same), Remuneration to the board of directors, independence (Number of non-executive directors) and Board Ownership (Shareholding pattern of promoter) and the ROA of 30 Indian companies, listed on the BSE, have been collected for the five year period of 01/04/2009 to 31/03/2014 and analysed using SPSS, employing the statistical tools of correlation, regression and Mean.

6. ANALYSIS AND INTERPRETATION

6.1 PATTERN OF ROA AND CORPORATE GOVERNANCE OF 30 COMPANIES

The pattern of ROA and various corporate governance variables of the 30 companies studied over the five year period has been displayed in Table.1.

Table.1. Trend of ROA and Corporate Governance During 2009-2014

Variable	Mean	Variable	Mean
ROA	0.89	Board Size	12.69
Total Remuneration	2.13	Independence	8.63
Board Ownership	4.06	Duality	0.31

It can be inferred from Table.1 that the Average Number of directors in Board are 12.69, of which 8.63 are non-executive and independent directors while promoters are 4.06. The positions of Chairman and MD have been held by a single person in the case of 31% of the companies.

6.2 RELATIONSHIP BETWEEN CORPORATE GOVERNANCE VARIABLES AND ROA

The relationship prevalent between the corporate governance variables studied and ROA of the 30 companies have been explored using Correlation Analysis and the results have been displayed in Table.2.

Table.2. Relationship between ROA and Corporate Governance

Variables	ROA	B. Size	Total Remuneration	Independence	Board Ownership	Duality
ROA	1					
B. Size	0.091	1				
Total Remuneration	-0.028	-0.047	1			
Independence	-0.024	0.667*	0.068	1		
Board Ownership	0.217*	0.053	-0.054	-0.180*	1	
Duality	-0.164**	0.182	0.082	-0.003	-0.026	1

It can be inferred from Table.2 that corporate governance variables of Board Ownership and Duality have significant positive and negative relationship respectively with ROA.

6.3 IMPACT OF CORPORATE GOVERNANCE VARIABLES ON ROA

The impact exerted by the corporate governance variables on ROA of the 30 companies studied have been explored using Regression Analysis and the results have been displayed in Table.3.

Table.3. Impact of Corporate Governance Variables on ROA

Variable	Coefficients	Standard Error	t	p	F	Sig.	R^2
Constant	0.073	0.018	3.98	0.000	2.750	0.021	0.087
Board Size	0.022	0.002	1.542	0.125			
Board Remuneration	4.16	0.000	0.145	0.885			
Independence	-0.002	0.002	-0.951	0.343			
Board Ownership	2.39	0.000	2.203	0.029			
Duality	-0.033	0.015	-2.204	0.029			

It can be inferred from Table.3 that the independent variables explain merely 9% of variance of the dependent variable. The significance value of 0.021, which is less than 0.05, suggests that the model is significant at 5% level.

Furthermore, it can be inferred from the table that Board Ownership and Duality are the two variables exerting significant impact on ROA at 5% level. The former is casting the maximum positive impact while the latter is exerting negative impact.

The following Regression model can be arrived at by using the Regression results:

ROA = 0.073 + 2.39 * Board Ownership - 0.033 * Duality

7. FINDINGS AND SUGGESTIONS

The study has revealed that size of board, remuneration to directors and composition of independent directors in the board fail to cast any sort of impact on the financial performance of firms listed in the Bombay Stock Exchange. However, the two corporate governance variables of board ownership and duality are exerting significant impact on financial performance. Presence of promoters in the board has exerted a significant positive impact on financial performance. Hence, it can be observed that presence of promoters in the board is the single corporate governance variable which shall significantly enhance financial performance of a firm. Interestingly, the study reveals that if Chairman and Managing Director positions of a firm is held by a single person, financial performance of that company will be adversely affected. Hence, it is clear that companies should assign the posts of Chairman and Managing Director to two different persons and have maximum promoters in their board to enhance their financial performance.

8. CONCLUSION

Emphasis on corporate governance may or may not have a telling effect on financial performance of a firm. However, if a firm has two different persons as its Chairman and Managing Director, its performance might have an upsurge. Similarly, existence of promoters in board may also enhance the financial performance of firms. Promoters possess higher degree of interest in the growth and prosperity of the firm as they treat the firm as their own child. Hence, more promoters in the board will definitely enhance the performance of a company.

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