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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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CORRELATION BETWEEN CORPORATE GOVERNANCE PRACTICES AND FINANCIAL PERFORMANCE OF THE COMPANY: CASE OF 5 INTERNATIONALLY ACCLAIMED INDIAN FIRMS

SHWETA SATIJA
FORMER ASST. PROFESSOR
SHYAMLAL COLLEGE (M)
UNIVERSITY OF DELHI
NEW DELHI

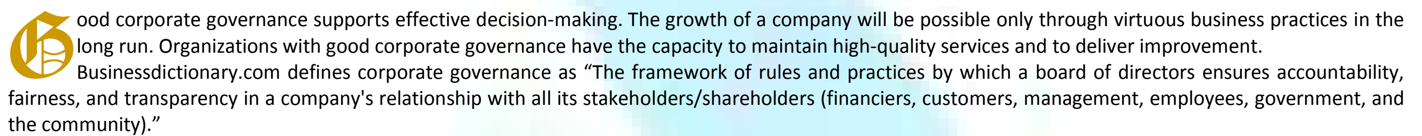
ABSTRACT

Corporate Governance exists today at an intricate crossing of law, uprightness, and commercial proficiency. Aspect of corporate governance influence on the firm's valuation has become one of the emerging issues in the field of management today. It is known since long and almost imperative that a corporate unit will acquire a life of its own which eventually leads to a gap between the ownership of the enterprise and its management, giving rise to governance issues. Corporate Governance is needed to create a corporate culture of consciousness, transparency and openness. It enables a company to maximize the long-term value of the company's performance. In this context, an attempt is made in this paper to study various Corporate Governance practices followed by 5 companies in India. Various studies in diverse domains like accounting, economics, finance, law and management (Mishra et al. 2001; Kwak, 2003; Black et al. 2003) have been conducted as to whether corporate governance has any impact on the determination of firm's value and performance. A sample of five multinational companies of Indian origin is studied based on the Corporate Governance practices that are being followed by them. This will include factors like Composition of the Board, Board Configuration, Formation of Committees, Number of Independent Directors and jobs carried by them, Conflict of interest and System of information dissemination. The paper aims to objectify and conclude if a relationship exists between corporate governance and firm performance. It is found in the study that corporate governance practices have limited impact on both the share prices of the companies as well as on their financial performance.

KEYWORDS

corporate governance, dissemination, firm performance, information, multinational.

INTRODUCTION



Good corporate governance supports effective decision-making. The growth of a company will be possible only through virtuous business practices in the long run. Organizations with good corporate governance have the capacity to maintain high-quality services and to deliver improvement.

Businessdictionary.com defines corporate governance as "The framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders/shareholders (financiers, customers, management, employees, government, and the community)."

Companies have a choice to follow either of the two models:

- Stakeholder model – Where the company takes care of all its stakeholders especially the public, or
- Shareholder model, whose scope is limited in nature as it focuses only on shareholder benefits,

Corporate governance is gaining prominence for all companies lately. Past decade and half has seen a rise in corporate scams that have led to increased awareness among investors about their rights to more transparent and professionally managed company business. The legal and legislative arena has also witnessed various changes due to these corporate scams. Whenever anything goes wrong within the company, it is the corporate governance mechanism that faces investigation.

HISTORICAL BACKGROUND OF CORPORATE GOVERNANCE

Most of the Asian countries did not have any legislation regarding corporate governance till the early 1990's. Corporate governance has been hotly discussed in the USA and Europe over the past two decades. It was only with the introduction of reports like the Cadbury report in UK and the COSO internal control framework in US that Corporate governance gained momentum The corporate governance code proposed by the Confederation of Indian Industry is modeled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom. On account of the interest generated by Cadbury Committee Report, the Confederation of Indian Industry, the Associated Chambers of Commerce and Industry (ASSOCHAM) and the Securities and Exchange Board of India (SEBI) constituted Committees to recommend initiatives in Corporate Governance. the Code of Corporate Governance in India in 1999 and similar developments on this front in other Asian countries. In India, Clause 49 of the listing agreement was introduced as a result of the recommendations of the Kumarmangalam Birla Committee on Corporate Governance. The Securities Exchange Board of India constituted the committee in 1999 but the agreement was actually implemented in 2006. Examples of other South Asian countries like Japan and South Korea also witnessed new governance laws like Japan Corporate Governance Forum in 1998, the Korea SE Act and the Commercial code in 1999. Further frauds like Enron and World Com gave birth to the Sarbanes Oxley Act 2002 in US which laid down very stringent rules regarding auditor's independence, composition of the board and audit committee. In Japan also, in June 2006, J-SOX was passed. It contains certain provisions of the securities legislation (Financial Instruments and Exchange Law) with provisions being quite similar to US SOX.

All these developments had a common objective - To cultivate and endorse a code for Corporate Governance.

In the Indian context, the need for corporate governance has been emphasized because of the scams occurring frequently since the advent of the notion of liberalization from 1991. We had the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. Probably, the CWG scam didn't attract as much international attention as the Satyam Scandal. It would be fair to say that, in India, corporate governance gained prominence more or less after the Satyam scandal. Lot of research work has been done to discover the reasons that led to these scams. Some research works revealed that lack of transparency and independent management were one of the reasons for the Asian crisis whereas some of the articles mentioned that the crisis exposed such problems. Organizations like the IMF stressed on having good governance practices to prevent such crisis from happening in future.

It is generally accredited that solidifying the Board of Directors of a company is the best defense versus inadequate governance. Specialists are of the belief that a watchful pairing of various factors, including sufficient communication to directors; answerability; proficiency and activism from promoters may aid in applying effectual corporate governance in India.

INDICATORS/PARAMETERS OF GOOD GOVERNANCE

It is believed better the governance model; more efficient would be the asset utilization. An investor looks for return in a company while investing. To analyze the safety of his investment, the investor studies the following set of parameters with which governance can be measured both quantitatively and qualitatively.

- Existence and Composition of the board (including the number of executive and non-executive directors namely independent directors and affiliated/ nominee directors),
- Remuneration to the board members,
- Relations with shareholders (including participation in the AGM) ,
- Accountability and audit,

- Formation of committees to oversee critical procedures
- Factors like independence of the directors or independence of the auditor are measured from the qualitative aspects and not quantitative.
- Investors rely heavily on financial statements and reports prepared and published by the company for any information about it. One of such reports is the annual report.

REVIEW OF LITERATURE

Corporate Governance is not a new topic in research. Sufficient financial disclosure has always been expected of the firms in the market. It is also considered as a prerequisite for Efficient Market Theory. But in reality that has not always been the case. Singhvi and Desai (1971) did an empirical analysis of the quality of corporate financial disclosure. In the study, they determined that inadequate corporate disclosure in annual reports will lead to wide-ranging instabilities in the market price of those securities.

Corporate Governance term came into limelight with the Cadbury Committee Report (1992), which was a committee, formed in UK due to a large spate of financial scams and corporate failures in the 1980s. The London Stock Exchange, the Financial Reporting Council and the accountancy professionals formed it. The main aim of the committee was to discuss about financial aspects of Corporate Governance. This report was followed by Greenbury Report (1995) which was a study on Director's remuneration; Hampel Report (1998) was a committee on Corporate Governance and Turnbull Report (1999) which talked about obligations of directors.

Zahra and Pearce (1989) in their study propose specific links among four board attributes (composition, characteristics, structure and process) and three critical board roles (service, strategy and control). The study integrates research findings on the impact of boards of directors on corporate financial performance and an integrative model of board attributes and roles is presented.

Birla, K. (1999)- In India's case also, in 1999 SEBI constituted a committee under Kumarmangalam Birla to recommend corporate governance measures to be followed by Indian companies. SEBI felt a need to regularise the disclosures by the companies in wake of scams like MS Shoes etc. The committee came out with a report in 2000 but it was not implemented immediately. The recommendations were considered to be too strict in Indian context. But after the Enron scam in 2002, another committee was formed under Narayan Murthy (2003) to come up with concrete measures to implement corporate governance. The recommendations of these two committees took the form of Clause 49 of the listing agreement and finally implemented in 2006.

Mark S Beasley (1996) in his study did an empirical test to determine that inclusion of large number of outside members in the board of directors led to a significant reduction in the likelihood of financial statement fraud.

Charreaux and Desbrières (2001) discuss a very crucial point of difference between stakeholder value and shareholder value.

Lacker, Richardson and Tuna (2007) in their working paper series on Corporate Governance, Accounting Outcomes, and Organizational Performance, examine the relation between a broad set of corporate governance factors and various measures of organizational behaviour and managerial performance. Through their empirical research they find that typical structural indicators of corporate governance have very limited ability to explain managerial behaviour and organizational performance.

Afsharipour, Afra. (2009) in her article on Corporate governance in India, examines recent corporate governance reforms in India as a case study for evaluating the competing claims on global convergence of corporate governance standards. India's reform efforts demonstrated that while corporate governance rules may converge on a formal level with Anglo- American corporate governance norms, local characteristics tend to prevent reforms from being more than merely formal. India's inability to effectively implement and enforce its extensive new rules corroborates the argument that comprehensive convergence is limited, and that the transmission of ideas from one system to another is highly complex and difficult, requiring political, social and institutional changes that cannot be made easily.

DATA AND METHODOLOGY

As India is among the top four countries in Asia on the basis of GDP in 2010, therefore study of governance led issues and achievements are all the more relevant. For the purpose of this study, five multinational companies of Indian origin have been chosen. The benchmarks for picking them was that they have a global existence, are famous brands and belong to the top companies in India on the basis of turnover. A deliberate effort has been made to choose companies belonging to diverse industries that are a blend of manufacturing and service sector. All of the chosen are listed companies on major stock exchanges and in some instances on other countries' stock exchanges as well.

Major sources of data collection were:

- websites of the companies,
- published reports, and
- annual reports of the companies.

Data for five comprehensive years ranging from FY 2005-06 to FY 2009-10 was used from prominent financial websites including the data for share price of each company which was taken from the time period Jan 1 2006 to 30 September 2011. All the data collected was secondary in nature.

It would be apparent at this stage to introduce few formulae's and mention the parameters used:

- Return on Assets = Net Income / Total Assets. It is expressed as percentage. Return on asset measures company's earnings in relation to all the funds it has at its disposal.
- Return on Equity = Net Income / Shareholder's Equity. It is also expressed in percentage terms. Return on Equity measures how much return the company on the money invested by the shareholders is generating. It is one of the most important parameters for the investors in the company.
- The data for Return on Assets and Return on Equity is taken from Jan 1 2006 to June 2011 from the annual reports of the companies and their respective websites.
- Factors specific to Corporate Governance were measured and data for all the five companies was composed for the period FY 2005-06 to FY 2010-11. Following were the factors chosen:
  - **Composition of the Board and Board Configuration**– This factor talks about total number of directors, number of executive, non-executive and independent directors. This shows how independently the board functions
  - **Formation of Committees and their details** – This factor details the number of committees related to corporate governance that each company has and their constitution. This shows how committed the companies are towards fulfilling their corporate governance obligations.
  - **Procedure and Sources of Information Dissemination**– This factor talks about how open the company is regarding disclosures such as board compensation, related party transactions, implementation of corporate governance principles, linking of senior management's remuneration with profits of the company and an internationally recognized independent auditor.

The paper attempts to define a co-relation between good governance practices of a company and its performance in the stock market and its subsequent financial performance.

CORPORATE GOVERNANCE IN INDIA

Corporate governance is a way of directing and controlling the company. In India, Corporate governance is restricted to Clause 49 of the listing agreement which forms part of the corporate governance initiatives in India that are dictated mainly by the Companies Act 1956, Securities & Exchange Board of India (SEBI) and Department of Public Enterprises (DPE). The Corporate governance norms are very stringent and disclosures are obligatory. Clause 49 of listing agreement provides for the composition of Board of Directors, the remuneration of the non-executive directors, composition and functions of the Audit Committee, role of the Board of Directors and Audit Committee of the holding company vis-a vis the subsidiary company, Disclosure and Compliance reports etc.

Like corporate governance norms in United States and United Kingdom, India's corporate governance norms follow a fiduciary and agency cost model. With a focus on agency model of corporate governance, Clause 49 includes detailed rules regarding the role and structure of the corporate board and internal controls. These norms lay criterions for:

1. Appointment of independent directors in board
2. Appointment, composition and Powers of Audit Committee
3. Functioning of Remuneration Committee, Investor Grievances Redressal Committee
4. Compensation that can be paid to non executive directors
5. Adherence to internal code of conduct by board of directors and other top executives.
6. Disclosure of Accounting policies, Contingent Liabilities, Related Party Transactions, IPO Proceed Utilization.
7. Certification by CFO/CEO on efficacy of Internal Control System, correctness of reported financials
8. Whistle Blower Policy

Source: http://www.iica.in/images/SEBI.pdf

Keeping the norms in mind , the following table gives the corporate governance disclosures in the five companies selected from India. These five companies were selected as they have worldwide presence, a noticeable brand name and are from varied businesses including both manufacturing and services sector. As all five of these are listed companies in India, they have to strictly follow the guidelines given by SEBI regarding corporate governance.

TABLE 1: CORPORATE GOVERNANCE REPORT OF INDIAN COMPANIES

PARAMETERS OF EXCELLENCE	INDICATORS OF SUCCESS	BHARTI	INFOSYS	LARSEN & TOUBRO	TATA MOTORS	VIDEOCON
Area of Expertise		Telecom	Software	Manufacturing & Engineering	Automobile	Electronic Appliances
Year of Establishment		1995	1981	1938	1945	1987
Head Office		New Delhi, India	Karnataka, India	Mumbai, India	Mumbai, India	Mumbai, India
Exchanges Listed		India	India/US	India	India/US	India
Board Composition	Executive Directors	2	6	8	2	2
	Non Executive Directors	8	Nil	9	4	Nil
	Independent Directors	8	9	Nil	6	8
Constitution of Committees	Audit Committee	Yes	Yes	Yes	Yes	Yes
	Remuneration Committee	Yes	Yes	No	Yes	Yes
	Investor Grievance Committee	Yes	Yes	Yes	Yes	Yes
	Nomination Committee	No	Yes	Yes	Yes	No
	Other Committees	ESOP	Risk Management	Nil	Ethics	Finance
Disclosure Guidelines	Board Compensation	Disclosed	Disclosed	Disclosed	Disclosed	Disclosed
	Related party Transaction	Disclosed	Disclosed	Disclosed	Disclosed	Disclosed
	CG Report	Full	Full	Full	Full	Full
	External Auditor	Batliboi	BSR	Sharp & Tannan	Delloite	Khandelwal Jain & Co.

The norms do not define or limit companies on the number of committees that should be formed. The guidelines hold provision for each company to set up their corporate governance committees according to its own needs and requirements. All the Indian companies have internationally well-known external auditors.

In addition, Table 2 below depicts the financial performance of Indian companies in terms of their share prices which is reflected in the data ranging from the year 2006 till 2011.

TABLE 2

SHARE PRICES OF THE CHOSEN INDIAN COMPANIES

Period	infosys	Videocon	Tata Motors	Bharti	L&T
02-Jan-06	2978.85	429.88	141.86	169.75	306.52
02-Jan-07	2272.45	454.61	175.55	316.5	488.77
02-Jan-08	1749.4	802.8	141.23	483.4	1386.93
02-Jan-09	1130.95	127.67	29.93	352.4	551.14
02-Jan-10	2614.25	239.67	138.87	328.8	1125.2
02-Jan-11	3445	216.8	261.26	358.4	1325.96

Source: www.moneycontrol.com

FIG. 1

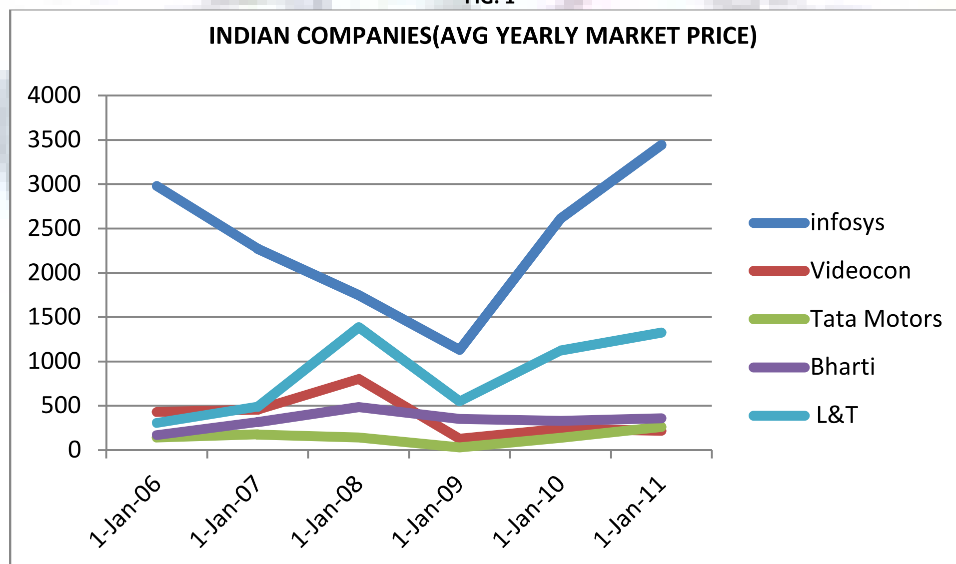


TABLE 3: AVERAGE FINANCIAL PERFORMANCE OF INDIAN COMPANIES

AVERAGE FINANCIAL PERFORMANCE OF INDIAN COMPANIES					
	Bharti	Infosys	L&T	Tat Motors	Videocon
Return on Assets	19.2%	32.88%	14.88%	11.44%	5.92%
Return on Equity	28.33%	32.88%	26.15%	20.90%	12.35%

FINDINGS FROM THE STUDY

1. Infosys has consistently performed well financially followed by Bharti Airtel, Larsen & Toubro, Tata Motors and Videocon.
2. It seems that both in case of Infosys and Videocon, the financial performance is related to the governance practices followed. Infosys is the world leader in disclosure. Its Board exercises its fiduciary responsibilities in the widest sense of the term. It has won numerous awards for being one of the most transparent and has stretched itself beyond the mandatory disclosures. Among the Indian firms, it is a trendsetter for voluntary disclosure of lot of items. Infosys has always enjoyed high market capitalization as it follows the best corporate governance practices in the world. It discloses both mandatory and non-mandatory information in its published reports. Disclosure of non-mandatory information by companies is rarely seen. The result of such unconventional practices is reflected its share price which has always performed well.
3. The only exception in this case is seen in case of Bharti Airtel. The governance practices over the last six years are more for show but financially the company has done well.
4. Despite very less or no independent directors on board, both companies -Tata Motors and Larsen & Toubro, have still managed decent share prices.
5. But in case of Bharti Airtel and Videocon, at the outset they seem to be following all the governance norms set by the government but in reality looking at their five year history of corporate governance, it does not seem that the corporate governance rules of the country are being followed in letter or spirit. The same can also be said for their share prices that have been weakening for the same time period.
6. The better the governance practices better is the financial performance.

CONCLUSION

Each country's model for corporate governance is based on the rules and practices of their own country. In the study, it was seen that India follows stringent corporate governance practices based on the shareholder model (followed in US). In this paper an attempt has been made to analyze and study whether any relation exists between corporate governance and various return parameters considered important by investors such as Return on Assets, Return on Equity and the movement in share prices. Increase in returns can be analyzed by the rise in share price. Based on the consideration that investors want to gather an insight into the company's functions, for which they rely on annual reports which carries financial information and other related information including corporate governance.

Due to local legislations and requirements, it has been observed that annual reports of most of companies have a separate section on corporate governance. This section covers most of the mandatory disclosures like board functioning and its independence, shareholders rights, conflict of interest, details of the various committees, their constitution and frequency of meetings.

It is seen in the study that corporate governance practices do have an impact on the share prices of the companies as well as on the financial performance of the companies as there is a strong relationship between stock price and the corporate governance practices of the company. But it is a very limited impact and should not be seen in isolation of other factors affecting the share price and the financial performance. If a company is open for scrutiny and is willing to share all information with the shareholders, its stock price is expected to do better as compare to a company which does not disclose all information. Corporate Governance practices though are only one of the factors affecting the share prices.

Similarly, financial performance of the company is also expected to be better if the company follows better governance practices.

In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum.

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