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   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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IMPACT OF CORPORATE GOVERNANCE PRACTICES ON THE FIRM PERFORMANCE: AN EMPIRICAL EVIDENCE OF THE SMALL AND MEDIUM ENTERPRISES IN INDIA

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ABSTRACT

The present paper throws light on the various factors influencing changes occurring in organizational climate and culture by the adoption of corporate governance in small and medium enterprises in India and several external forces affecting this practice. Attempts have been made to identify the relationship between the corporate strategy development and the relative increase in the performances in such firms using factor analysis and regression analysis techniques. In these contexts, corporate governance data are grouped into four different factors: ownership component, board development, committee component and board procedure component. Tobin's Q-method is used to evaluate the firm's performance.

KEYWORDS
Corporate governance, Tobin's Q.

INTRODUCION
World over, the SME sector has grown rapidly over the years and contributes almost 40 percent of the total industrial output. This sector has occupied an important position in generating revenue for countries because the growth rate in this sector has consistently been higher than the average industrial growth rate. At present, there are three sectors recognized by the government of India: cottage and tiny industry, small-scale industry, and large-scale industry. However, a definition exists only for tiny and small units; medium sized enterprises are not defined either technically or legally. But, Confederation of Indian industry (CII) an independent agency in India has recognized a firm with Rs.1 Crore (Rs 10 million) investments as a SME. The definition used by CII is based on the level of investment in plant, machinery or other fixed assets whether held on an ownership, lease or hire purchase basis. It seeks to keep in view the socio economic environment in India, where capital is scarce and labor is abundant. The SME in India characterized by low capitalization and limited assets, geographical diversity and high mortality, poor access to capital markets, cash intensity in transactions, lack of credit information, poor financial disclosure on account of tax issues, directed lending based on central Bank guidelines, high risk perception has led to high borrowing costs. In spite of all these limitations, SMEs in India are reckoned as one of the most vibrant sectors of the economy. Over the years, this sector has played a significant role in the development of Indian Industry sector (Figure-1). This is one of the fastest growing sectors in India.

REVIEW OF LITERATURE
The literature on the corporate governance suggests that the relationship between corporate governance and the value of a firm (performance) is affected by the endogeneity among the corporate governance variables. Larcker, Richardson and Tuna (2004) find a weak relationship between the value of a firm and corporate governance. Similarly, Bauer, Gunster and Otten (2003) do not find any relationship between the value of a firm (performance) and corporate governance variables. They argue that lack of a significant relationship between these variables is due to endogeneity and selection bias among the variables. The endogeneity in regression makes the coefficient of variables inefficient and unreliable affecting the robustness of the result of the hypotheses. The endogeneity among the variables in this study will be tested and suitable treatment will be given to solve this problem. Again, Black (2001), Klapper and Love (2003), Gompers, Ishii and Metric (2003) and Beiner and Schmid (2005), have said that corporate governance plays an important role in improving the performance of a firm and there is a direct relationship between the two in both developing and developed financial markets. So, in this paper, an attempt has been made to study the effect of corporate governance practices in small and medium enterprises in India by considering several corporate governance variables classifying into four components as follows:

OWNERSHIP COMPONENT
- Family share holdings
- Private corporate shareholdings
- Public shareholdings

BOARD COMPONENT
- Ratio of the executive directors to total directors
- Ratio of the non-executive directors to total directors
- Duality in board (CEO in board chairman or not)

BOARD PROCEDURE COMPONENT
- Head of the audit committee
- Head of the remuneration committee
- Head of the shareholders grievance committee

BOARD COMMITTEE COMPONENT
- Size of the board
- Number of committees in the board

Again the corporate governance in India, CII has stated that "Corporate Governance deals with laws, procedure, practices, and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants in particular, its shareholders, creditors…. There is a global consensus about the objective of good corporate governance: maximizing shareholders value", Subsequently Security and Exchange Board of India (SEBI) has come out with report on C.G. It stated that "…. a fundamental objective of corporate governance is the enhancement of shareholders' value keeping in view the interests of other shareholders…."

PRACTICE OF CORPORATE GOVERNANCE IN SMEs IN INDIA

The practice of adoption of 'corporate governance' shows a wide range of variation in the context of developed and developing countries. In developed countries, the awareness towards C.G. is more, as a result of that, ownership concentration is less and legal protection of minority shareholders is relatively strong. But, in the developing countries like India, ownership is highly concentrated with identity of family shareholders, which is an important difference. Different researchers like Shlefier and Vishny (1997), Agrawal and Knoeber (1996), Jensen and Warner (1988) studied particular aspects of adopting corporate governance practices in small and medium enterprises and the relative gain in performances by these firms. Also, it was found that a company with a highly concentrated ownership structure has superior performance. Family firms are businesses in which a single family exercises significant management and financial authority (Leach, 1994). Casson (1999) stated family shareholders are widely considered as the owners and residual claimants who control firms that largely belong to their own family and pass the firms assets to their descendents rather than wealth to shareholders. Family firms are corporations in which the founder or their descendents have a major role in managing the firm Randoy and Goel, (2000). Jennings (1997), Francis (1997), studied the role of family ownership on firm performance. The performance indicators used are market to equity ratio, and stock returns. When firms with family ownership are compared with non-family ownership, the former have higher ME/ BE and stock market returns than firms with non-family ownership or closely held ownership. Thomsen and Pedersen (2000) investigated the identity of controlling ownership and firm performance indicators such as market to book value, return on assets, and sales growth of companies in 12 European nations. He suggested that family ownership is related to negative market to book value and return on assets compared to institutional investors and the result in sales growth regression showed that growth rates are significantly higher in firms with family owners. Jira and Sudhir (2004) examined the relationship between family ownership and firm performance in Thailand between 1998 – 2000. They have used market returns, return on asset, and net income to sales as performance indicators. The results showed that family ownership is positively significant to profitability, but it is less significant to market returns. The empirical evidence concerning the possible association of firm performance and corporate governance is extremely limited. This paper tries to explain family owned firms influence on board governance practices. The board governance variables used in this paper are board size, outsider ratio, CEO as chairman of the board, and Board meetings. The justification of inferring a relationship between board composition and performance is implied by the impact of the decision-making authority of the board on the firm performance. Baysinger and Butler (1985) and Hambrick and Jackson (2000) found evidence for the proportion of independent non-executive directors to be positively correlated with the accounting measure of performance. Further, Agrawal and Knoeber (1996) found a negative relationship between board independence and firm's performance. Hermalin and Weisbach (1991) and Bhagat and Black (1999) used the approach of Tobin's Q as performance measure, on the ground that it reflects the 'value added' of intangible factors such as governance (Yermark, 1996). Jensen (2000) found that large boards can be less effective than small boards. Similar inverse relationship between board size and performance has been reported by Yermark (1996), Eisenberg et al.(1998), Mak and Kusnadi (2005), Andres et al.(2005). According to Indian company's act 1956, the board of directors is the ultimate governing body on company affairs. Hsiang-Tsai, (2005), Bonn (2004) studied the role of the board and board size regarding the firm's performance. Lawerence and Stapledon (1999) and Garg (2007) found that different proportions of board independence have dissimilar impact on firm performance and suggested that it is important to have some independent board of directors. According to SEBI listing clause 49, not less than 50 % of the total number of directors should be an independent non-executive director. In the case CEO as a chairman of the board, at least half of the board should have independent directors. Past research have shown mixed results on performance influence of outside versus inside directors on firm performance. Most of the researches have support outside board members influence on firm performance. Argued there is high degree of association between outsider ratio and firm performance. They found board with high proportion of outside directors works effectively. It is common practice that CEO of the firm may act as chairman of the board of directors. There is contrasting opinion among researcher regarding CEO of the firm concurrently acting as chairman of the board. One set of researchers argued against it, just because board effectiveness may come down drastically due to lack of independence. On the other hand, CEO can give ultimate direction to the boards regarding company's future strategy and able to run in a proper way. Hsiang-Tsai (2005) discussed the role of CEO in the board and its implications from various angles. Kyereboah-Coleman and Biekpe (2005) proved that CEO duality is negatively related to the performance of a firm in the developing market. The division of role of CEO and Chairman is important as it enables the board to carry out its duties more effectively. According to SEBI, listing agreement 49, minimum four board meetings must be held in a year with time gap not exceeding 4 months between two meetings. CII code on corporate governance has recommended minimum of six meetings in a year. Each meeting should hold at an interval of every two months. The logic behind this exercise is to examine and question the executive actions. Executives are held responsible for the way they conduct the business in the board meetings. There is relationship exists between number of board meetings held and firm performance.

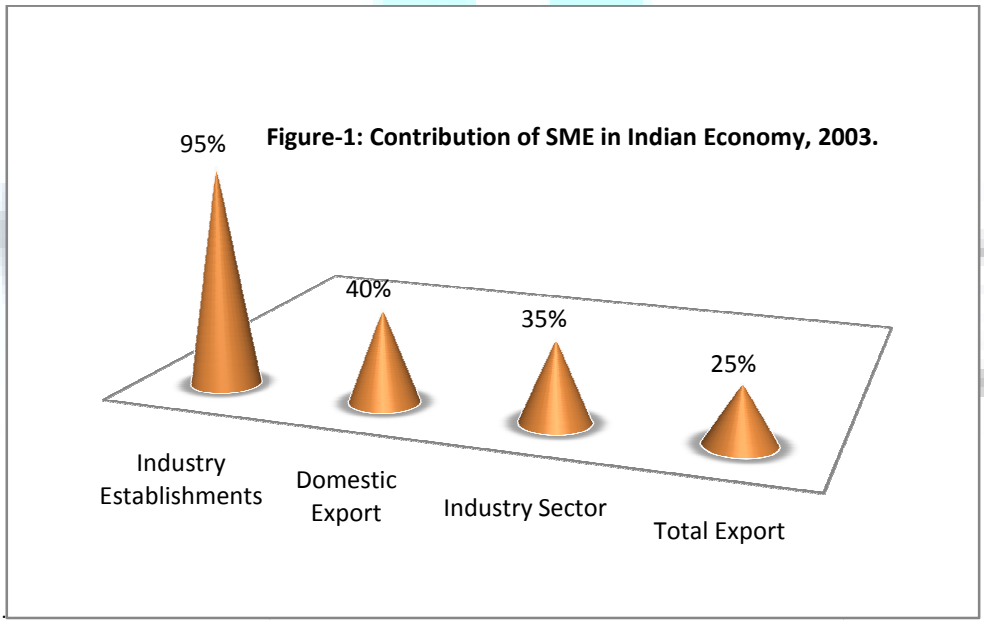

Figure-1: Contribution of SME in Indian Economy, 2003.

SOURCES OF DATA AND METHODOLOGY

The data used in this paper has been obtained from Prowess, a financial database of Center for Monitoring Indian Economy (CMIE) and annual reports of the firms. The sample consisting of 50 cross sectional firms have been taken from firms listed in Small Cap Index of Bombay Stock Exchange (BSE) as on 31st March 2009. Data used for different variables are considered during the time period 1st April, 2008 to 31st march, 2009. Different variables considered in this paper are as under:

TABLE 1: DESCRIPTION OF THE VARIABLE

Dependent Variable	Independent Variables		Control Variables
Firm Performance **(Y)**	Concentrated Ownership **(X_1)**	Percentage of share held by Concentrate Ownership	Firm Age **(X_{12})** (It is considered as the logarithm of the number of years since the firms were established. Jira & Sudhir, (2004), Khanna and Palepu, (2000))
	Private Corporate Ownership Percentage **(X_2)**	Percentage of share held by private corporate body	
	Public Ownership **(X_3)**	Percentage of share held by Indian Public	
	Executive Ratio **(X_4)**	Ratio of Executive director to total directors	
	Non-Executive Ratio **(X_5)**	Ratio of Non-Executive director to total directors	Debt to Equity Ratio **(X_{13})** It is measured by dividing total debt by total equity (Sarkar and Sarkar, 2000).
	Duality **(X_6)**	If CEO as a Chairman of the board, then 0 if not 1	
	Head of Share Committee **(X_7)**	If Independent non-executive director is head of the shareholders' committee, then 1 if not 0	
	Head of Audit Committee **(X_8)**	If Independent non-executive director is head of the shareholders' committee, then 1 if not 0	
	Head of Remuneration Committee **(X_9)**	If Independent non-executive director is head of the shareholders' committee, then 1 if not 0	Sales to Market capitalization Ratio **(X_{14})** (Sample firms consist only of service firms. So this measure is used to explain firm's financial performance with respect to firm's market capitalization of equity shares.)
	Board Size **(X_{10})**	Total number of directors in the board	
	Committees **(X_{11})**	Total number of committees in the board Control	

Also, factor analysis is used to analyze the interrelationship between the independent and dependent variables.

ECONOMETRIC MODEL

The econometric model for estimating the firm performance(Y) is given by the following equation:

$$Y = \beta_0 + \sum_{i=1}^{m} \beta_i \; X_i \; + \in \; ,$$

Where β_0 is a constant, β_i 's are multiple regression coefficients and $\in$ is the error term. By using the above mathematical model we are estimating the firm's performance basing upon the values of all the 14 variables on all the 50 firms. The values of β_0 and β_i are determined by using least square regression technique. To measure the firm's performance, we use Tobin's Q method, which is as follows:

$$Q = \frac{MVE + LVPS + BVB + BVCL}{BVTA}$$

Where, MVE = Market Value Equity,
LVPS = Liquidation Value of Preference Share,
BVD = Book Value of Debt,
BVCL = Book Value of CL,
BVTA = Book value of Total Assets = FA + INV + CA.

This method of computing Tobin's Q was given by Chung and Pruitt (1994) who report that this computation approximates the actual q to the extent of 96%. The modification was being done to make it compatible with the manner of reporting in the Indian context. Tobin's Q is an unambiguous measure of value-added by the management and can also capture the value of future investment opportunities. Garg (2007) studied the performance of firms basing upon directly Tobin's Q value as well as taking logarithmic specification duo to non-linearity and found that the results regarding the performance remains unchanged. MVE is calculated by multiplying year-end closing pricing of the share with outstanding equity shares. The year-end closing price varies widely in a year; the average stock price at the end of each quarter (June 30, September 30, December 31, and March 31) is taken into consideration. The BVTA is calculated as on 30th, March 2009.

RESULTS AND DISCUSSION

Factor analysis is used to discern the underlying dimensions or regularity in phenomena. Its general purpose is to summarize the information contained in a large number of variables into a smaller number of factors. These are a number of factor-analytical techniques. When the variables are interrelated in a complex fashion, then factor analysis may be used to untangle the linear relationship into their separate patterns. The statistical purpose of factor analysis is to determine linear combinations of variables that aid in investigating the interrelationships. Here, we reduce the large number of variables to certain underlying constructs or dimensions that will summarize the important information contained in the variables, so that our purpose is to discover the basic structure of a domain and to add substantive interpretation to the underlying dimensions. Factor analysis accomplishes this by combining the questions to create new, more abstract variables called factors. In general, the goal of factor analysis is parsimony: to reduce a large number of variables to as few dimensions or constructs as possible.

TABLE-2: FACTOR ROTATED COMPONENT MATRIX

Factor/ Criteria	Factor-I	Factor-II	Factor-III	Factor-IV
Concentrated Ownership (X_1)	0.852			
Private Corporate Ownership Percentage (X_2)	-0.769			
Public Ownership (X_3)	-0.747			
Executive Ratio (X_4)		-0.898		
Non-Executive Ratio (X_5)		0.898		
Duality (X_6)		0.551		
Head of Share Committee (X_7)			0.499	
Head of Audit Committee (X_8)			0.751	
Head of Remuneration Committee (X_9)			0.822	
Board Size (X_{10})				0.658
Committees (X_{11})				-0.720
Eigen Value	**2.229**	**2.066**	**1.645**	**1.257**
Percentage of variance	**20.922**	**18.765**	**14.923**	**11.687**
Cumulative percentage of variance	**20.922**	**39.687**	**54.610**	**66.297**

Here the factor analysis reduces various interdependent variables into four factors. These factors can be analyzed to study the performance of the farms. For the validation of factor analysis we consider the KMO (Kaiser-Mayer-Olkin) measure of sampling adequacy, which is 0.876 at 95% confidence level. It indicates that factor analysis is an appropriate technique to be used. Using principal component analysis for identifying the factors, the four factors are:

Factor-I : Ownership component **(X_1,X_2, X_3)**
Factor-II : Board component **(X_4,X_5, X_6)**
Factor-III : Committee component **(X_7,X_8, X_9)**
Factor-IV : Board procedure component. **(X_{10},X_{11})**

TABLE-3: ORDINARY LEAST SQUARE REGRESSION ANALYSIS

Criteria	Unstandardized Coefficients	Standardized Coefficients	t- test	p-value
Concentrated Ownership (X_1)	2.976E-02	0.010	0.065	0.945
Private Corporate Ownership Percentage (X_2)	3.015E-02	0.012	0.067	0.946
Public Ownership (X_3)	2.957E-02	0.010	0.061	0.944
Executive Ratio (X_4)	-0.654	-0.207	-1.438	0.158
Non-Executive Ratio (X_5)	0.654	0.207	1.438	0.158
Duality (X_6)	-0.586	-0.204	-1.437	0.157
Head of Share Committee (X_7)	0.930	0.299	2.120*	0.042
Head of Audit Committee (X_8)	0.892	0.289	2.117*	0.042
Head of Remuneration Committee (X_9)	0.887	0.286	2.117*	0.042
Board Size (X_{10})	-0.552	-0.177	-1.234	0.224
Committees (X_{11})	-0.499	-0.174	-1.232	0.223
Firm Age (X_{12})	-5.502	-0.322	-2.176	0.035
Debt to Equity Ratio (X_{13})	-0.564	-0.175	-1.234	0.218
Sales to Market capitalization Ratio (X_{14})	-0.545	-0.268	-1.867	0.068
F-Test	**P – Value**	**R**	**R squared**	**R squared adjusted**
2.835*	**0.023**	**0.616**	**0.468**	**0.322**
Standard Error of Correlation Coefficient			**0.07**	

OLS regression analysis is used to determine which corporate governance components have influence over firm performance. From the table, it is clear that the committee component has significant influence over firm performance. It shows that the committee factor really played very crucial role in influencing firm performance because it has 't' statistics value of –2.182 at 95 percent confidence level. It is evident from the table that head of the committees have definite influence over firm performance. It is understood from the data that most of committees have independent non-executive directors as a head of the committee. So, it is concluded that non-executive independent directors contribute very significantly to the firm performance. Further, firm's age is the only control variable that has statistically significant relationship with firm performance.

CONCLUSION

In this paper, an attempt has been made to analyze the small and medium enterprises in the Indian economy as these SMEs have significant contributions in affecting Indian economic scenario. The corporate governance practices were being widely adopted by these firms in order to gain competitive advantage. So, in an attempt to study the firm's performance various statistical techniques like Factor Analysis, Principal Component Analysis and Multiple Regression techniques were used to analyze the firm's performance. The sample firms are extracted from Bombay stock exchange (BSE), because it has constructed 'BSE Small- Cap' index to track the performance of the companies with relatively small market capitalization that would exclusively represent the mid and small cap companies listed on the Stock Exchange. These firms (Indian private service firms) have been categorized as SME based on the market capitalization. The factor analysis clearly identified four factors based on corporate governance practices followed in the Indian private service firms. Subsequently, these four factors were submitted for OLS regression analysis in order to prove that corporate governance practices in Indian private service firms have positive influence on the firm performance. It is evident from analysis part of this paper that Indian private service firms' corporate governance practices have positive influence on firm performance. Particularly, committee component factor has statistically very significant relationship with firm performance. Further, firms' age has negative relationship with firm performance. Finally, this paper concludes that non-executive independent directors have contributed very significantly towards firm performance.

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