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# A REVIEW ON CORPORATE GOVERNANCE IN INDIA: IMPACT ON FIRM PERFORMANCE

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***Abstract***
*Corporate India witnessed the burgeoning economic growth since the 1990s that brought to the forefront the need for Indian companies to adopt corporate governance standards and practices, which are in line with international guidelines. This paper contributes to the existing literature by providing a review of the conceptual as well as empirical researches in the area of corporate governance and firm performance by highlighting the relationship between the corporate governance mechanisms (board size, board composition, frequency of board meetings, CEO duality) and firm performance. The research findings are contradictory and inconsistent. Some studies founded a strong positive association while some reported negative relationship between corporate governance mechanisms and firm performance while others did not found any significant relationship between the two.*

***Key Words: Corporate governance, Firm performance, Board size, CEO duality, Tobin's Q.***

## 1. INTRODUCTION
### 1.1 Corporate Governance
Corporate Governance is a process or set of systems and principles to ensure that a company is managed to suit the best interest of its stakeholders. Corporate Governance is the system by which companies are directed and controlled. It promotes corporate fairness, transparency, integrity and accountability. Good corporate governance ensures: protection of the interest of shareholders; disclosure and transparency in business transactions; compliances of statutory and legal framework; ethical conduct of business; and Commitment to values to stakeholders.

Cadbury Committee, 1992 definition of Corporate Governance is most widely used, which states that Corporate Governance is "the system by which companies are directed and controlled". The board of directors is responsible for the governance of their companies. The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that appropriate governance is in place. According to OECD Principles of Corporate Governance- "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." Shleifer and Vishny (1997) defined as, "Corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investments". Sir Adrian Cadbury in the preface of his World Bank publication, *Corporate Governance: A Framework for Implementation,* states the following: "Corporate Governance is holding the balance between economic and social goals and between individual and community goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of these resources. The aim is to align as nearly as possible the interest of individuals, corporations' and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement". As per Standard and Poor's definition "Corporate Governance is a system in which a company organizes and manages itself to ensure that all financial stakeholders receive their fair share of a company's earnings and assets." According to CII's (Confederation of Indian Industry) draft code, "Corporate Governance deals with laws, procedures, practices and implicit rules that determine a Company's ability to take managerial decisions vis-a-vis its claimants, particularly its shareholders, creditors, state and employees." From the above said definitions it can be concluded that corporate governance encompasses authority, accountability, leadership, stewardship, direction and control exercised in the process of managing the functioning of the organization.

### 1.2 Firm Performance
A wide variety of definitions of firm performance has been proposed in the literature. Performance can be related to the organisational ability in meeting its targets and goals. Firm performance is thus the effectiveness of a firm in achieving goals and targets within specified time frame. The performance of a firm can be measured using two kinds of measures: Market based and accounting based. The existing literature on corporate governance used both the type of measure. Market based measures are based on the market value. These measures are helpful for investors as they help them in taking their investment decisions on future performance of the company based on its past and present performance. The various market based measures are Price to Earnings Ratio, Earning per Share, Economic Value Added, Tobin's Q, Market Value Added, Market to Book Value Ratio etc. In corporate governance literature Tobin's Q as a proxy for firm performance was used extensively. However accounting based measures are considered more reliable as the firms listed in various exchanges have to follow

various national and international principles while recording their financial statements. These measures correspond to the past performance of the firm. Various accounting based measures like Return on Assets (ROA), Return on Equity (ROE), Return on Capital Employed (ROCE), Net Profit Margin, Return on Sales (ROS) etc. were used in past studies.

## 2.0 HISTORICAL BACKGROUND OF CORPORATE GOVERNANCE IN INDIA

Corporate India witnessed the burgeoning economic growth since the 1990s that brought to the forefront the need for Indian companies to adopt corporate governance standards and practices, which are in line with international guidelines. The Confederation of Indian Industries (CII) headed the move to bring corporate governance issues to the attention of Indian companies and also led to the introduction of legislative reforms prescribing the manner in which Indian companies could implement effective corporate governance mechanisms. The document titled Desirable Corporate governance: A Code was released in 1998 focusing on listed companies. The code was voluntary and contained detailed provisions. Although the code was less welcomed and adopted by few companies. SEBI has played a significant role in establishing norms for corporate governance in India. Over the years, SEBI constituted two committees to make recommendations relating to corporate governance for listed companies in India, viz., the Kumar Mangalam Birla Committee (2000) and the Narayana Murthy Committee (2003). These committees made various recommendations relating to the composition of the Board of directors of listed companies, meetings of the Board, audit committee, audit reports, independent directors, code of conduct, financial disclosures etc. The Committee recognizes that compliance with the recommendations would involve restructuring the existing boards of companies. The recommendations were implemented through Clause 49 of the Listing Agreements, in phased manner by SEBI. Clause 49 of the Equity Listing Agreement consists of mandatory as well as non-mandatory. The clause consist of 8 sections dealing with the board of directors, audit committee, remuneration of directors, board procedures, management, shareholders, report on corporate governance and compliance respectively. Companies listed in India have to adhere with the provisions of Clause 49.

The Ministry of Corporate Affairs had also appointed the Naresh Chandra Committee on Corporate Audit and Governance (2000) in order to examine and recommend various corporate governance issues in India. The committee basically considered the two key aspects of corporate governance viz. financial and non-financial disclosures, and independent auditing and board oversight of management. Subsequently, the MCA also appointed the J.J. Irani Committee in 2005 to review the international best practices in corporate governance, in light of the growing needs of the Indian economy and corporate. The recommendations of these committees form the bedrock of the legal regime for corporate governance in India.

MCA had also set up a National Foundation for Corporate Governance (NFCG) in association with the CII, ICAI and ICSI, to provide a platform to deliberate on issues relating to good corporate governance to facilitate exchange of experiences and ideas amongst corporate leaders, policy makers, regulators, law enforcing agencies and non- government organizations.

## 3.0. REGULATORY ASPECTS: COMPANIES ACT 2013 AND THE AMENDED SEBI CLAUSE 49 OF THE LISTING AGREEMENT

The Companies Act was enacted on August, 2013 which provides for major overhaul of corporate governance norms for all companies. The Companies Act 2013 envisages radical changes in the area of corporate governance and is set to have far reaching implications. Securities Exchange Board of India (SEBI) with the objective to align with the provisions of the Companies Act 2013, issued revised Clause 49to adopt best corporate governance practice and to make corporate governance norms more effective. The revised Clause came into effect from October 1, 2014 except for the clause relating to the constitution of a risk management committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year.

Revised clause 49 lays down the principles of corporate governance. The listed companies have to adhere to the principles and are expected to interpret and apply those provisions in alignment with the principles. The key components of the principles are (a) Rights of Shareholders (b) Role of stakeholders in Corporate Governance (c) Disclosure and transparency (d) Responsibilities of board of directors and other responsibilities. Many of the principles laid down in this framework are aligned with powers, duties and expectation from various stakeholders especially directors and management in the Companies Act 2013.

The key impact areas of corporate governance in the Companies Act 2013 includes Board structure and responsibility; disclosure and reporting; risk, control and compliance; secretarial compliances; related party transactions (RPT), loans and investments; audit and auditors; and corporate social responsibility.

**Table-1 Comparison of Provisions of Corporate governance under Revised Clause 49 and Companies Act, 2013**

| Particulars | Revised Clause 49 | Companies Act, 2013 |
|---|---|---|
| Woman director | Have to be complied with effect from October1, 2014. | It provides 1 year transition period to comply with the requirements. |
| Limit on number of directorships for independent directors | Maximum 7 listed companies as independent director except where such person is WTD; the limit is upto 3 directorships. | The 2013 Act provides overall limits on number of directorships by an individual i.e. maximum 20 companies (including 10 public companies). However, no specific limit is prescribed for Independent Directors |
| Tenure of Independent director | The maximum tenure of an Independent Director is capped at 10 years. However, if a person who has already served as an Independent Director for 5 years or more on 1 October 2014, will be eligible for appointment for a term of 5 years only. | The overall term of an Independent Director is ten years, except that under the 2013 Act, these requirements are applied prospectively. |
| Constitution of Audit Committee | Two-thirds of the members of the Audit Committee shall be Independent Directors. The Chairman of the Audit Committee is to be an Independent Director. | The Audit Committee is to be formed with majority being Independent Directors i.e. more than half of the board to be independent. No specific requirement for the Chairman to be an Independent Director. |
| Related Party Transactions | All material related party transactions shall require approval of the shareholders through special resolution and the related parties shall abstain from voting on such resolutions. | All related party transactions which are not in the ordinary course of business or not at arm's length basis should also be approved by the Board and shareholders. However, shareholders' approval is required for only certain transactions with the criteria for such approval defined differently. |
| Risk Management Committee | The revised Clause 49 inserts a new requirement (for only top 100 listed companies by market capitalisation as at the end of the immediate previous financial year) that a company shall also constitute a Risk Management Committee. | The 2013 Act does not contain similar requirements. |
| Separation of Offices of Chairman & Chief Executive Officer | No explicit provision earlier. Introduced as a non-mandatory provision. | Separation required unless articles of the company permit otherwise or the company does not has multiple businesses. |

## 4.0. LITERATURE REVIEW

### Relationship Between Corporate Governance Mechanisms And Firm Performance In India

Mishra S. and Mohanty P. (2014) in their study examined the corporate governance issues in India in order to establish the relationship between corporate governance and financial performance using a sample of 141 companies belonging to the A group stocks listed in the Bombay Stock Exchange of India covering 18 industries. They developed a composite measure of corporate governance comprising of three indicators-legal, board and proactive indicators. The results of the multiple regression performed step-wise using ROA as a proxy for firm performance revealed that the board indicators (CEO-duality, board size, board composition, number of board meetings, Frequency of attendance in the board meetings) and proactive indicators influence the firm performance significantly. The results concluded that composite corporate governance measure is a good predictor of firm performance.

Sahu T. K. and Manna A. (2013) empirically investigated the effect of corporate board composition and board meetings on performance of 52 Indian manufacturing companies listed in Bombay Stock Exchange over a period of 5 years (2006-2011).

They represented Board composition by board size, number of executive directors, board independence, and Chairman's identity. Corporate performance is measured through Net sales, Net Profit, Return on Capital Employed, Earning per share, Tobin's Q, Economic value added and Market value added. Multiple regression Ordinary Least Square model results indicated that board size and board meetings have a positive impact on corporate performance whereas the independence of the board and presence of non-executive chairman in the board has negative impact whereas the proportion of executive directors in the board was found insignificant.

In a similar line, Bijalwan J. G. and Madan Pankaj (2013) analyzed the relationship between board composition and firm performance for 121 firms listed on BSE for the year 2010-2011. Financial performance of the firm is measured with the financial ratios viz. Return on Capital employed, Return on the equity, Profit after tax and Return on assets. The study found that there exist a significant positive relationship between board composition and firm performance. Also board size and firm performance are significantly related but the strength of relationship is not strong. Larger boards are less effective than smaller boards except in case of PSUs in India. Also the standard board sizes vary according to the nature of the industry.

The efficacy of outside directors on the corporate boards of 157 non-financial Indian companies listed on BSE in the year 2008 was examined by Kumar N. and Singh J.P. (2012). Using Tobin's Q as a performance measure, it was found that outside directors has a negative effect on the firm value mainly due to non-executive non-independent directors, where as independent directors have a positive but insignificant effect. It was concluded that the companies with a greater proportion of independent directors have more market value. Thus independent directors require a greater representation on board in lieu of other non-executive outside directors.

Kota, H.B., and Tomar, S. (2010) examined the effect of corporate governance practices on the performance of 106 mid-sized firms in India between 2005 and 2007. When Tobin's Q was used as a measure of financial performance, it was found that the ratio of non-executive directors to total directors have no significant relationship with the performance. However it was found that CEO duality structure contributes positively and significantly to the firm performance. A significant inverse relationship between board size and firm performance was also reported.

Garg A. K. (2007) studied the data of 164 companies from the BSE 200 companies for six financial years from 1997-98 to 2002-03 to examine the relationship between board independence, board size and firm performance. He used Tobin's Q, Ratio of operating income to assets, ratio of assets to sales and Market-adjusted stock price returns as measures of firm financial performance. According to the findings of his study smaller boards are more efficient than the larger ones; the board size limit of six was suggested as ideal, as the study founded an inverse association between board size and firm performance. Also board independence was inversely related with firm performance and the study suggested that the proportion of independent directors should be between 50 and 60 percent. Board size and performance as also board independence were found to be inversely related which means that a bad performance leads to an increase in both size as well as board independence.

Ghosh Saibal (2006) examined the nexus between corporate performance and boards of 127 non-financial listed manufacturing firms for the year 2003 by using two accounting measures i.e. ROA and PERF( arithmetic mean of ROA, ROS, ROE) and market based method i.e. Tobin's Q. The results suggested that board size exerts a negative influence on corporate performance irrespective of accounting and market based measures. This means that larger boards tend to have a dampening influence on firm performance. Also there exists a positive association between the number of non-executive directors and firm performance. The study also found evidence to suggest that CEO compensation has a positive influence on corporate performance, judged in terms of accounting measures.

Kathuria Vinish & Das Shridhar (1999) examined the association between board size and corporate financial performance using data on 504 corporations belonging to 18 industries for the year 1994-95. The results of the study suggested that the size of board plays an important role in influencing the financial performance (profitability) of corporations. A Corporation's performance improves by increasing the board size & contribution of an additional board member decreases as the size of the corporation increases. Thus larger organization which already have a high average board size, do not gain much if an additional board member joins. However the results failed to indicate any significant role of directors' equity ownership in influencing the performance.

**5.0 CONCLUSION**

Corporate governance and firm performance relationship studies in India gained momentum over the last decade. The literature on corporate governance in India examines the efficacy of the various board parameters. While there is increasing evidence of the failure of certain governance structures, the empirical evidence to date is mixed and gives little coherent evidence for the shape of an optimal governance structure. The reason could be that the existing theories have not been sufficiently complete to include all major determinants of good corporate governance. The issue of corporate governance is Highly complex as there will never be one optimal governance structure because no two firms, two markets, or two cultures are exactly the same. Ultimately governance structure needs to be determined by a combination of the above factors and their dynamics.

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