# The Impact and Relationship of Corporate Governance with the Stock Performance of Companies in the India Corporate Sector.

Vidur Mittal
Briarcliff High School
Briarcliff Manor, NY, 10510

## 1. Introduction

The volume of research done in the field of Corporate Governance has increased dramatically in the past decade. Corporate Governance (CG) is a field in economics that investigates how to secure efficient management of companies by the use of Board polices and incentive mechanisms. Corporate Governance deals with several broad issues that cover principles of law, economics, management as well as sociology. However, in the context of a Corporation that has a wide base of shareholders and is managed by professionals, the core principles of sound Corporate Governance are as follows: Protecting the rights of all stakeholders, Equal treatment for minority, foreign and major shareholders, timely and accurate disclosure through financial statements, Effective composition & management of the Board and a CEO elected by the Board committee with adequate experience, who must strive for firm and positive relationship with all members of the company. (OECD Principles of Corporate Governance, 2004)

The way business is run matters to all of us. We need the good services it produces, the employment it provides and the wealth it creates. Its prosperity nourishes the spirit of mankind. For prosperity to occur Corporate Governance (CG) principles must be adhered to and that's what makes CG such a pertinent topic in today's world.

CG deals with several broad issues that cover principles of law, economics, management and sociology. CG has two different impacts on today's market. Poor CG undermines the foundation of the trust that needs to exist between professional managers and shareholders. This has many implications. It has an impact on investor confidence, especially if it is widely pervasive. This in turn hinders the ability for the company to get fresh money in the market putting constraints on its growth.

Other than impacting the world market, good governed companies also have better management which intern creates a level playing field. This can result in a much more congenial business atmosphere for all stakeholders representing the corporation. *(Klapper and Love, 1991)*

Understanding CG systems is essential for all nations. This is because to tolerate a poor system is to impose upon oneself unnecessary competitive handicap.

Overall, in all circumstances the effectiveness of CG has major implications on companies, nations, and on the World to either survive and prosper or falter and fail.

**2. Review Of Literature**

Why do some companies perform better as determined by their stock performance, market share and/or profitability, than other companies? Assuming that all other factors are constant, are differences in the quality of their Corporate Governance (CG) responsible for this difference in performance? For many directors and CEOs this is a troubling question, as they do not have a clear and concise answer.

Additionally, the concept of CG is poorly defined. The narrow view of looking at CG is that "CG is concerned with ensuring the company is run in the interest of shareholders." A broader and more liberal view is that "CG is a field in economics that investigates how to secure efficient management of companies by the use of incentive mechanisms and polices." Most of the literature and research done on CG has taken the narrow path *(referred earlier)* such as literature by R.Edward Freeman *(Stockholders and Stakeholders: A New Perspective on CG, 1983)* and Chad Leechor *(Protecting Minority Shareholders in Closely Held Firms, 1999).*

Various studies have been conducted to examine the role of CG on companies operating in different legal environments. It has been concluded that CG behavior has a more powerful effect on market value and company performance in a country where legal constraints on corporate behavior are weak. For example, in a study by Bernard Black from Stanford Law School, a comparison was made between companies in Russia and the U.S. It appears that CG issues had a larger impact on the stock market performance of companies in Russia while governance behavior of corporate companies in USA has affected their market value only minimally. *(Black, 2001)* While this is counterintuitive, there could be several explanations of this behavior. Companies listed on the National Association of Securities Dealers Automated Quotations (NASDAQ), New York Stock Exchange (NYSE) or the American Stock Exchange (AMEX) need a minimum requirement of quality CG which is much higher than that required for companies listed on the Russian stock exchange (RTS). Russian companies exhibit a wide variation in the quality of CG since, laws governing behavior and company management remain weak and inadequate. This legal inefficiency prompts Russian companies to adopt and adhere to the principles of CG, to counterbalance the weakness in their country's laws, inviting and offering greater investor rights. In the process they get rewarded by the investors through higher stock prices. *(Black, 2001)*

In a recent report, Credit Lyonnais Securities Asia (CLSA) calculated an index with CG rankings for 495 companies across twenty-five emerging markets and eighteen sectors. The statistics present in the CLSA report show that companies ranked high on the index have better company performance and higher stock returns. Further analysis of this index by earlier researchers *(Klapper and Love, 2004)* has led to the conclusion that the

average governance is higher in countries with a stronger legal protection framework. This framework supports the argument that improving the efficiency of the legal system in the country leads to an increase in average company performance.

What defines and individualizes a good CG system from a bad CG system? Are having a larger number of Executive directors than Non-executive directors on the Board committee better or worse? Concentration of Ownership, should one person hold most of the power and money or should the power and money be distributed among larger group of people. All these questions convey signs of disparities in CG among countries. For example, in the United States, large share holdings and majority ownership are relatively uncommon, simply because of legal restrictions on high ownership and exercise over companies. In contrast, India has a plethora of companies where the ownership is heavily concentrated on one individual. *(*Kumar*, 2003)* Therefore, this disparity in CG mechanisms among different CG systems (Note: disparity is also vivid in the same CG system) creates a strong foundation for future research.

The Sarbanes Oxley (SOx) Act of 2002 provides further reinforcement for better CG for public listed companies in the U.S. SOx is a broad ranging initiative that is aimed at improving financial disclosure and scrutiny for US Companies. It was created after an era of corporate financial scandals in which managers were not taking control or taking control in the wrong way, by directing companies in a way that didn’t benefit the employees, the shareholders, the investors, and the market in general (e.g. Enron and WorldCom). The SOx law further provides legal support for principles of good CG by laying down the rules for corporate disclosures and penalties for defaulters, thereby protecting investors.

A long-term study of the relationship of corporate governance with stock prices, returns and corporate governance was conducted by the Rodney L White Center for Financial Research. Their results clearly exemplify the fact that companies with weaker shareholders rights, which is a glaring impairment in CG adherence, earned significance lower return, were valued lower, had poorer operating performance and not surprisingly affianced in higher capital expenditure and takeover activity. *(Gompers and Metrick, 2001)*

Why has CG become such a prominent topic in the past two decades? It has reached such eminence because companies have started to realize that their downfall may well lie in the lack of good CG principles. Events such as the 1998 East Asia crisis and a series of U.S. scandals and corporate failures in the past few decades have also stimulated the importance of CG. *(Todd Mitton, 2000)*

In addition, Bhagat and Black state that statistical evidence in the U.S suggested low or weak correlation between a company's governance attributes and its performance. For example, the proportion of independent directors in the Board was found to have statistically no impact on company performance. However, this could have been a result of low shareholder activism in the past before corporate scandals like Enron and WorldCom broke out. These events have led to renewed focus on issues related to CG. Therefore, there is some merit in exploring the impact of CG issues on company performance pre and post the corporate scandals at WorldCom and Enron.

**3. Research Questions**

1. Does quality of Corporate Governance matter in company performance?
2. What Corporate Governance practices have a greater effect on company performance, as delineated by corporations in India?

**3.1 Research Hypothesis**

1. A higher quality of CG strongly elevates company's performance whereas a poor CG system can significantly hamper a company's performance?
2. Proportion of Executive directors/Non-Executive directors, Concentration of shares, Shareholders pattern will all have a significant impact on company performance.

**4. Indian Corporate Sector:**

The researcher chose the Indian Corporate Sector as the experimental setting as it offers the following advantages over other emerging market economies: *(Kumar, 2003)*

- The Indian Corporate Sector has several hundred companies, lending itself to a large sample pool.
- It is by and large a hybrid of the "outsider systems" of countries like USA, UK and the "insider systems" of countries like Continental Europe and Japan.
- The legal framework for regulation of all corporate activities including governance and administration of companies, disclosures, share-holders rights, has been in place since the enactment of the Companies Act in 1956 and has been fairly stable.
- At no time has India faced the kind of financial crises, which has affected the economies of East Asia in terms of exchange rates, large current account deficits,

fiscal imprudence leading to disproportionate external financial exposure, imbalance between short term and long term liabilities, and lax financial supervision. (Ownership Structure and Corporate Firm Performance, 2003)

- India has had a well-established regulatory framework for more than four decades, which forms the foundation of the Corporate Governance system in India.

**5. Methods & Materials**

The research was done by analyzing 40 companies listed on the Bombay Stock Exchange-200 index (BSE-200). The researcher confined the analysis to BSE listed companies only because all the listed companies are required to follow the norms set by Securities and Exchange Board of India (SEBI) for announcing their financial accounts. The BSE also has the second largest number of domestic quoted companies on any stock exchange in the world after NYSE, (more quoted companies than London or Tokyo). All companies were chosen by a simple random sample (SRS). The one stipulation while picking the companies was that they could not be listed on the BSE-200 as a banking company. A simple random sample was the decided approach, so that minimum bias would be present in the data and in the results.

There were two categorical variables in this project. The independent variable was the Corporate Governance characteristics, which are more clearly defined later on and the dependent variable was the company performance, as defined and measured using various factors. The legal framework in India, being a developing country, was far less stringent than the likes of the United States of America or England. *(Kumar, 2003)*Thus, the researcher hypothesized and was supported by previous research done by Bernard

Black that CG behavior has a more powerful effect on market value and company performance in a country where legal constraints on corporate behavior is weak. This led the researcher to believe that his results would be far more conclusive and far more constructive if the data was collected from a developing country such as India.

In order to attain CG characteristics for the selected companies listed on the BSE-200 the EDIFAR (Electronic Data Information Filing And Retrieval System) database was used from the Securities and Exchange Board of India (SEBI). SEBI in association with National Informatics Center (NIC) has set up the EDIFAR website to facilitate filing of certain documents/statements by the listed companies on line on the web site. This would involve electronic filing of information in a standard format by the companies. Each company's annual reports and corporate governance report was retrieved and analyzed from the year March 2005. (Note: some companies did not have the data available in the specific time period thus the next closest time period was used. Such a difference is negligible to the end result) In addition to using the annual report and corporate governance report, the researcher used the shareholding pattern from March 2005 for each company. Corporate Governance measures and indicators were chosen based largely on a Corporate Governance framework formulated by the OECD Principles of Corporate Governance in 2004. There were nine corporate governance principles tested in this project:

I. Number of Board Committee members.
II. Proportion of Executive Directors on the Board.
III. Proportion of Non-Executive Directors on the Board.
IV. Number of Board Committee Meetings.

V. Number of Audit Committee Members

VI. Number of Audit Committee Meetings

VII. Percentage Shares held by Promoters.

VIII. Percentage Shares held by Institutional Investors ( i.e Banks, Financial Institution, Insurance Companies)

IX. Percentage of Shareholders holding 95% of Shares as a measure of ownership concentration

Once the independent variables were gathered, the researcher gathered the data that represents the dependent variable: Company performance. There are many measures of performance such as Revenues / Profit Growth or increase in Market share. However the researcher chose to measure it through calculating the annual rate of return on the company's stock. The annual rate of return is the rate per annum at which your investment grew. First the year-to-year growth for each stock was calculated using the following equation:

$$G=((P_t-P_0)/P_0*100$$

Where:

G = Year to year growth rate (%),

$P_t$ = Closing price of share at the end of the review period,

$P_0$ = Beginning Price of the review period.

Stock Splits and Stock Bonuses/Dividend are accounted by applying the equivalent factor to $P_t$, the ending period price.

In a Stock Split, typically the face value of the stock is split reducing it to a lower value and giving shareholders more number of these lower face value shares. Thus a

1/10-split means you get 10 stocks for every stock held but the face value of each stock held is now lower by a factor of 10. In order to adjust for this one multiplies $P_t$ by 10 in the earlier equation.

Stock Bonus/Dividend is when the company pays you dividend in the way of new stock. Thus, if the stock dividend is announced in the ratio of 1:2, for every share held one gets 2 additional shares. In order to adjust for this one multiplied $P_t$ by 3, as an investor who held 1 share has 3 shares now.

After computing G one can divide the value of G by the number of years reviewed for the specific stock, to obtain the annual growth rate. This is called the simple annual growth rate. The researcher also computed the compounded annual growth rate. The relation between simple and compounded growth rate is as follows:

Using Simple growth rate G and solving for $P_t$ :

$P_t =$ $P_0 * P_0 G/100$

$P_0(1+G/100)$

Using Compounded growth rate g and solving for $P_t$:

$P_t =$ $P_0(1+g/100)$^4

Therefore:

$P_0(1+G/100) = P_0(1+g/100)$^4

(1+G/100) = (1+g/100)^4

g= ((1+G/100)^.25-1)*100

After calculating the annual compounded growth rate for all the stocks in the sample set, the researcher established their correlation with each of our independent variables. The correlation would provide an indication of the relationship this might exist

between good CG and the performance of the stocks. In order to analyze the relationship even further the researcher ran regressions using Microsoft Excel. (Redmund, Wat)

$Ri= a+ B_1C_i + B_2Z_1$

$a+ B1Ci + B_2Z_1$

$a+ B_1C_i + B_2Z_1 + B_2Z_2$

$a+B_1Z1+ B_2D_1$

Where a= Intercept, B= Coefficient, C, Z and D= Different Independent Variables.

These are all possible regression equations. The purpose of this was to see what variables in what combination have an effect on the performance. In order to judge significance the researcher used a 90% Confidence interval, therefore a P-value < .10 or a high T-statistic would mean that the CG indicator has a large impact on company stock return. The data was analyzed by experimenting different regressions to see which ones seem to have an effect and which did not.

**6. Results**

If corporate governance matters for company performance and this relationship is fully incorporated by the market, then a stock price should quickly adjust to any relevant change in the company's governance. Like most examples of legal origin and change, the governance structures of a firm are exogenous, so it is difficult in most cases to draw casual references. For this reason, the researcher makes no claims about the direction of causality between governance and stock market performance. Instead, the researcher analyzed whether governance measures are a useful variable for explaining returns on stocks and overall company performance.

The researcher performed several possible regressions with a plethora of different combinations and variables. With such a small sample of data it is tough to get strong correlations, as the results showed, however the results and numbers were very telling and informative for the needs of the research:

*6.1. Table 1:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 150.051807 | 30.39470485 | 4.936774602 | 2.22213E-05 |
| Proportion of Executive Directors | -127.2627929 | 81.96013383 | -1.552740179 | 0.130024187 |

In the first regression (see Table 1), the researcher used the Proportion of Executive Directors as our independent variable and the result was definitely interesting. Even though we are using a 90% confidence interval and thus the p-value< .10 to be considered significant, it was just above .10 and thus it is reasonable to conclude that the proportion of executive directors had a fair impact on the annual rate of return. The coefficient of the regression is negative thus there is an indirect relationship between the Proportion of Executive Directors and stock performance. This tells us that those companies with a higher proportion of Executive Directors in the composition of their Boards tended to have poorer stock performance. This is reasonable as independent directors are more likely to work in the interest of shareholders than executive directors, and this is reflected in the stock performance.

*6.2. Table 2:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 23.34438303 | 55.91749052 | 0.41747909 | 0.679031799 |
| Proportion of Non-Executive Directors | 128.2390943 | 79.82848442 | 1.606432782 | 0.117706849 |

In the second regression (see Table 2), the researcher used the Proportion of Non-Executive Directors as our independent variable and the result was the exact opposite as the first regression. Once again the P-value was just >.10 so the researcher can conclude that it had a fair bit of impact in the opposite direction. However this time the coefficient was positive, thus there is a direct relationship between the Proportion of Non-Executive Directors and the company stock performance. Therefore, companies with greater Proportion of Non-Executive Directors in their Board composition tended to outperform those who had less. This result is exactly what you would expect and reinforces the theory that independent Board oversight is key to the framework for good Corporate Governance and always good for the Company and its shareholders.

*6.3. Table 3:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 214.6907694 | 98.44311128 | 2.180861277 | 0.036903542 |
| No.of Board Meetings | -6.310055736 | 6.209605947 | -1.016176516 | 0.317411119 |
| No.of Audit Committee Members | -13.93310749 | 21.14172655 | -0.659033568 | 0.514740128 |
| No. of Audit Committee Meetings | -1.477306289 | 9.097757413 | -0.162381367 | 0.872059385 |

In the third regression (see Table 3), the researcher sees that all the P-values seemed to be much >.10 thus there doesn't seem to be any correlation between the no. of Board and / or Audit Committee meetings and stock performance. The same held true for the number of members in the Audit committee. The researcher noted that most companies had broadly similar practices and thus there wasn't really much variance in the independent variable.

But overall it does show that the number of members or the number of meetings cannot compensate for the lack of independence in the supervisory Board.

*6.4. Table 4:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 152.1063813 | 27.51080161 | 5.528969437 | 3.86998E-06 |
| % Shares held by Promotors | -61.99191051 | 33.22244923 | -1.865964489 | 0.070955853 |

In the fourth regression (see Table 4), we had the strongest relationship, which was very similar to previous research done by Reik Lehmann and Jurgen Weigand (2000). The major concern in the debate on the separation of ownership and control is whether managers of widely-held companies pursue their own interests rather than maximizing shareholder value. In a pioneering study, Thone and Poensgen (1979) found significantly lower returns on equity for companies with large ownership control.

This study corroborates the conclusions cited above. As shown in Table 4, with a p-value of .07, and a negative coefficient the researcher can confidently say that a larger % shareholding by Promoters has a negative impact on stock performance. Thus, if the promoters (individuals who start the company) retain too much control after taking their company public, it appears to work against better stock performance.

*6.5. Table 5:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 97.08227205 | 18.31745875 | 5.299985843 | 7.61237E-06 |
| % Shares held by Banks, Financial Inst., Insurance Company | 48.67088569 | 36.1225158 | 1.347383609 | 0.187035799 |

In the fifth regression (see Table 5), with such a high P-value it is clear that there is no correlation between % shares held by Institutional Investors and performance. The researcher did not hypothesize there would be any, as local Banks and other institutional investors do not yet play the role of activist shareholders in India. However, this is likely to change as this market evolves.

*6.6. Table 6:*

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | 119.5698591 | 18.50050774 | 6.463058245 | 2.48521E-07 |
| % of shareholders holding 95% of shares | -38.78084173 | 36.48349328 | -1.062969531 | 0.295512823 |

In the sixth regression (see Table 6), the research shows that in contrast to Chibber and Majumdar (1998,1999,) Sarkar and Sarkar (1999:2000), shareholding pattern or ownership structure does not have a relation with stock performance, as the optimal ownership structure evolves over time. This was exactly the result of our regression as due to such a high P-value, company performance is clearly unrelated to the shareholding pattern. However, Promoter held stockownership concentration is an exception and this was noted in the previous section.

## 7. Discussions/Conclusions

At the start the researcher posed two research questions and two research hypothesis. From the results the researcher cannot indefinitely say that corporate governance has an effect on company performance since the regressions did not exemplify such a significant relationship. However, one can confidently say it has an impact as shown by previous research on CG, and the impact of Promoter ownership and proportion of executive/non-executive directors on company performance as illustrated in

our regressions. However the researcher recognizes that better corporate governance is advocated for reasons aside from enhancing firm value, such as fairness and equity. It is plausible that governance factors unrelated to firm value are important for other purposes. Future research should examine corporate governance in these and in other contexts.

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