An Empirical study on the relationship between Corporate Governance practices and financial performance of select corporate sectors in India.

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Abstract
Corporate Governance, has found its prominence and acceptance in most countries of the world as, "it includes making necessary disclosures and decisions, complying with the law of the land, commitment towards conducting the business in ethical manner and being responsible towards its stakeholders". Much has been heard, talked and said about the topic of corporate governance, but unfortunately the parameters to judge its practical implementation is still not very clear to many. Effective corporate governance not only helps in defining, implementation and monitoring company's objective but also helps in providing a structure that will ensure accountability to the shareholders involved in the organization. This article attempts to study the relationship between corporate governance practices and financial performance of select companies. The final conclusion of the study revealed that effectiveness of corporate governance determines the financial performance of companies.

***Key words**: Market capitalization, Corporate governance parameters, financial performance, Return on Capital Employed, Interest Coverage ratio, Tobin's Q and Clause 49.*

Introduction

Globalization has not only significantly heightened business risks, but has also compelled Indian companies to adopt international norms and good governance. Much has been heard, talked and said about the topic of corporate governance, but unfortunately the parameters to judge its practical implementation is still not very clear to many. It is the premise of apprehension for Indian corporate to initiate hard core actions so as to evolve and devour corporate governance at a rapid speed for their survival and growth.

Today, almost every country has institutionalized a set of corporate governance codes, spelt out the best practices and has sought to impose appropriate board structures. The corporate governance code is supposed to be enforced through the listing agreement with exchanges. The enforceability of the code is subject to enforceability of the listing agreement. Of the about 6,000 listed companies in India, only about 30 per cent (Deepak Sanchety, 2005)[1] comply with its provisions in an acceptable and meaningful manner. The well-known companies are always subject to fairly intense scrutiny by media and investors as far as compliance levels are concerned and any default in this respect, gets detected. Corporate governance practices are often questioned even in such better-known companies. What happens in the rest of the listed companies can only be conjectured. Companies rated high on corporate governance are few in number. Despite what may be called an ongoing corporate governance revolution, there exist no universal benchmark for effective levels of disclosure and transparency. Moreover, fulfilling the demanding standards can only ensure a proper balance between management, supervisory board and shareholders with adequate levels of transparency, appropriate compensation schemes and the prevention of conflicts of interest. All these entwined together as good corporate governance practices when considered in the policies, i.e., moving from an interest in order to one of progress, thus, provides a market oriented framework for the running of companies with transparency, trust and independence (Bryane Michael, 2003)[2].

I. The Concept of Corporate Governance

Organization for Economic Co-operation and Development (OECD) has defined corporate governance as, "procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization –such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making".

Corporate Governance describes how companies ought to be run, directed and controlled. It is about supervising and holding to account those who direct and control the management (Cadbury 1992). The purpose of governance structure is to assure a significant flow of capital to the financing of firms, corporate governance includes the structures, processes, cultures and systems that engender the successful operation of the organizations (Keasey, Thompson, & Wright, 1997).

Corporate governance aims at protecting the individual and collective interest of all the stakeholders. Good corporate governance practices may have significant influence on the strategic decisions of a company such as external financing that are taken at board level. Sound corporate governance principles are the foundation upon which the trust of investors and lenders is built. In a nutshell, the corporate governance is all about governing corporations in such a transparent manner and ensure all stakeholders' interest are protected, and with due compliance and applicable laws.

II. Review of Literature

Gruszcznski Marek (2006) has confirmed that the degree of corporate governance for listed companies in Poland is correlated with their financial performance. This study has shown a significant relationship between their governance rating, operating profit and debt leverage ratio. This study was conducted for the financial statements of 2002 and sample included 53 companies listed in Poland. The results of study have shown that companies with higher profit margin and lower debt leverage ratio are expected to have better rating of corporate governance.

Anurag Pahuja and B S Bhatia (2010) have analyzed the determinants of corporate governance disclosure. Their study seeks to determine the extent to which Indian listed companies disclose their corporate governance practices by examining the annual reports of 50 listed companies. The study reveals that there is a considerable gap in the sphere of extent, quantum and quality of disclosure made by companies in their annual reports. This study concluded that there is a substantial scope for improvements in the corporate governance disclosure practices.

Jiao Yawen (2011) has found the relationship between corporate disclosure, Market valuation and Firm performance. The study has shown a positive relationship between changes in disclosure rankings and the future unexpected operating performance. Tobin'Q has been used as measure of market valuation. This study has also found positive association between disclosure rankings and future net profit margins, research and development intensity.

Senan Neeti (2011) has analyzed the study of corporate governance in public and private sector enterprises in India. This study has provided an understanding of corporate governance disclosure levels. This study has focused on disclosure practices in the annual reports of firms for the year 2008-09 of 77 listed Indian companies by constructing Corporate Governance Disclosure Score. The results of the study have revealed that private sector companies adhere to higher standards of corporate governance disclosure than public sector companies.

Mujumdar and Chhiber (1999) in their study revealed a significant negative relationship in India between the levels of debt in the capital structure of the firm and performance. They argued that both short-term and long-term lending institutions are government-owned and it could be the reason behind this relationship. They advocated that CG mechanisms in the west would not work in the Indian context unless the supply of loan capital is privatized.

Khanna and Palepu (1999) have examined in their study found a positive linear relationship between insider ownership and performance of the firm in as single year, 1993, where both accounting (Return on Assets) and market based performance measures (Tobin's Q) were used. Van[8]*et al*., found that equity ownership of management Board and supervisory Board does not affect performance.

Van de Velde et al. (2005)analyzed the linkage of corporate governance ratings and financial performance, and found positive but not significant relationship between them. **Governance Metrics International and Byun (2006)** investigated the association between corporate governance ratings and financial performance, and found that companies rated in the top 10% of GMI's global database achieved a higher ROE, ROA and Return on Capital (ROC) than companies in bottom 10%.**Buchanan (2007)[7]** in his article talks about the concept of corporate governance in Japan. Here it is analyzed in terms of the concept of "Internalism", which stands for the belief that companies should be controlled by internally appointed managers who are integrated into their firms.

Selvaggi and Upton (2008) found that better governed firms yield higher risk-adjusted returns. They strongly emphasized that enhanced corporate governance is the cause of enhanced performance and not vice versa. **Eisenhofer (2010)[9]**concluded that, "good corporate governance fosters long-term profitability and it does, in fact, pay." However, **Core et al. (2006)[10]**; and **Statman and Gluskhov (2009)[11]**found no significant association between governance and financial performance. **Azim (2012)[12]**used Structural Equation Modeling (SEM) and observed that some governance mechanisms have positive covariance, while some have negative covariance. Thus, he arrived at no consistent and significant relationship between governance mechanisms and financial performance (as proxied by ROE, ROA, Market to Book Value Ratio, Price - Earnings Ratio and Dividend Yield).

Thus, we observe that some of the existing studies suggest positive and significant relationship; some suggest positive but insignificant relationship; while some studies suggest no significant association between corporate governance and corporate financial performance. Thus, existing literature provides mixed and inconclusive results and hence, further empirical examination is required to be done in this context to arrive at conclusive results.

III. Objectives of the Study

a) To study the factors influencing corporate governance practices in the select BSE and NSE listed companies in India.

b) To understand the relationship between corporate governance and financial performance of select BSE and NSE listed companies in India.

IV. Research Methodology

This study is about corporate governance practices and to identify the relationship between corporate governance and financial performance of BSE and NSE listed select Top 50 companies in India in terms of highest market capitalization. Annual reports of the year 2013-14 have been used for the study. The revised Clause 49 of the listing agreement of stock exchanges introduced by SEBI is taken as the benchmark and disclosure regarding corporate governance practices in the annual reports is compared. In this study corporate governance-related disclosure developed under 52 questions categorizing into Board structure, Board process, Transparency & Disclosure, Safety health, CSR Initiatives, Risk Management, Internal control systems & Adequacy, Board Committees, Investor Grievances Committee, Whistle Blower Mechanism and Independent Auditor's report. In order to arrive the overall disclosure score annual reports of each company under study were carefully scrutinized for the presence of specific items under the above mentioned categories. One point is award when information on an item is disclosed and zero otherwise.

V. Scope of the study

This study is about governance practices of BSE and NSE listed select 50 companies in India in terms of highest market capitalization. For the purpose of study of corporate governance practices, Annual reports of 2013-14 have been used for the select 50 companies. For the purpose of analyzing financial performance, 5 years average numbers of Annual reports for the period from 2009-10 to 2013-14 have been used. Of the 50 companies, 46 companies were commonly found in both BSE & NSE Index for the above period. The remaining 4 companies viz., Hexaware Technologies, Ambuja Cements, BOSCH Ltd and Amtek India were compiled based on Annual reports of 2012-13 due to non-availability of annual reports (2013-14).

VI. Rationale for considering highest market capitalization of top 50 companies for the study

a) The BSE & NSE index companies is well diversified stock index constituting for 24 sectors of the economy and it consists of being used for a variety of purposes such as benchmarking mutual funds portfolios, index based derivatives and index funds.
b) The select top 50 companies of average market capitalization constitutes 55% and 54% of total market capitalization of NSE and BSE index companies as on 31st Mar, 2014.

VII. Statistical tools used for Data Analysis

The data has been compiled and tabulated using SPSS and are processed using Excel. The researcher has used multiple regressions model and ANOVA table to analyze the data and to interpret the results.

VIII. Analysis and Findings

After reviewing national and international literatures pertained to corporate governance, the researcher has identified Market capitalization, Interest Coverage ratio, Average share price, Return on Capital Employed (ROCE) and Tobin's Q are important corporate governance outputs in any organizations.

The researcher questions at this moment how the corporate governance outputs are effectively create influence over financial performance of organization. Therefore researcher considers financial performance as dependent variables and Corporate Governance parameters as Independent variables. These parameters includes Board structure, Board process, Transparency & Disclosure, Safety health, CSR Initiatives, Risk Management, Internal control systems & Adequacy, Board Committees, Investor Grievances Committee, Whistle Blower Mechanism and Independent Auditor's report. The relationship between set of independent and dependent variables is obtained through linear multiple regression analysis as shown in Table-1 below.

Table-1-Result of Multiple regression analysis

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.920[a]	.847	.829	2.12731

Predictors: (Constant), Avg Share Price, ROCE (Return on Capital Employed), Market Capitalisation, Interest Coverage Ratio (EBIT/Interest) and Tobin's Q

Source: Author's own calculation

From the above table it is found that R square is equal to 0.847, adjusted R square is 0.829, this implies the independent variables corporate governance output create 84.7% variance over financial performance. The relationship between Independent and dependent variables is measured in the following ANOVA table-2

Table-2 Results of the ANOVA[a]

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	1099.199	5	219.840	48.578	.000[b]
Residual	199.121	44	4.525		
Total	1298.320	49			

a. Dependent Variable: Fin Performance Score %

b. Predictors: (Constant), Avg Share Price, ROCE % (Return on Capital Employed), Market Capitalisation (Rs in Crores), Interest Coverage Ratio (EBIT/Interest), Tobin's Q

Source: Author's own calculation

From the above table, it is found that corporate governance output are highly significant in determining the financial performance of any organization (f=48.578, P=0.000) the individual influence of corporate governance output variables are determined the following co-efficient Table-3.

Table-3 Result of the Coefficients[a]

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	46.259	.585		79.037	.000
Market Capitalisation (Rs in Crores)	4.023E-005	.000	.687	10.860	.000
Interest Coverage Ratio (EBIT/Interest)	.000	.000	.201	3.122	.003
ROCE % (Return on Capital Employed)	.098	.022	.368	4.466	.000
Tobin's Q	-.076	.041	-.150	-321.842	.072
Average Share Price	.001	.000	.292	4.874	.000

a. Dependent Variable: Fin Performance Score %

Source: Author's own calculation

From the above table, it is found that the Market capitalization (Beta = 0.687, t=4.874, p = 0.000), Average share price (Beta = 0.292, t=4.874, p=0.000), (Return on Capital Employed (Beta = 0.368, t=4.466, p=0.000) and Tobin's Q is the insignificant variables of corporate governance in measuring the financial performance. Therefore it can be concluded that in any organization, the effectiveness of corporate governance determines the financial performance of companies and also decides the sustainability.

IX. Conclusion

Majority of the sample companies are following the best governance practices and some of the companies are disclosure levels are beyond the requirements of the mandatory provisions of revised Clause 49 of SEBI.Companies should understand that improving governance and sustainability performance is as important as improving the financial performance. However it is also interesting to see the corporate governance practices of the companies outside the BSE & NSE index. This provides scope for further research.

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