Impact of Corporate Governance on financial performance of companies – A study with reference to select corporate sectors

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Abstract

Corporate Governance is not a new topic in research. Adequate financial disclosure has always been expected of the firms in the market. Corporate Governance term came into limelight with the Cadbury Committee report (1992) which was a committee formed in UK due to large spate of financial scams and corporate failures in the 1980s. It also gained further momentum after the sudden crash of Enron(2001), Xerox (2000), WorldCom (2002), Parmalat in Italy, Dawoo in Korea, Lehman Brothers (2008) followed by IT giant Satyam (2009). Lack of transparency and poor disclosures in the annual reports are blocking the shareholders from ascertaining the well-being of the corporate houses. As a result, regulatory authorities across the world made it compulsory for corporate sector to comply with the code of best Corporate Governance practices. The purpose of the study is to determine the relationship between Corporate Governance practices and financial performance of corporate sectors. Various researches have been conducted to investigate the relationship between corporate governance and financial performance, but the results have been mixed and inconclusive. In this paper, we examine and analyze the impact of corporate governance on financial performance of firm in an Indian context and final conclusion of the study revealed that best corporate governance practices ensures moderate performance to best performance in most of the companies.

***Key words**: Corporate Governance Disclosure score, Market capitalization, Board Committees, financial performance and financial variables.*

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INTRODUCTION

Corporate governance (CG) is the new buzz-word and invited much public attention in today's corporate world. Corporate governance also gained further momentum after the sudden crash of Enron(2001), Xerox (2000), WorldCom (2002), Parmalat in Italy,Dawoo in Korea, Lehman Brothers (2008) followed by IT giant Satyam (2009). Lack of transparency and poor disclosures in the annual reports are blocking the shareholders from ascertaining the well-being of the corporate houses. In many respects, corporate governance should be viewed by investors as a component of equity risk (Deutsche Bank report, 2004). Furthermore, it can be argued that corporate governance is particularly relevant in developing economies, where the injection of foreign investment is essential to economic growth. Today, shareholders are more vigilant about their rights. This has made it more important for the companies to disclose the various parameters in their Annual Reports depending upon the model of corporate disclosure being followed by legal authority. Various researches have been conducted to investigate the relationship between corporate governance and financial performance, but the results have been mixed and inconclusive. In this paper, we examine and analyze the impact of corporate governance on financial performance of firm in an Indian context.

I. THE CONCEPT OF CORPORATE GOVERNANCE

The meaning of the term corporate governance is debatable subject. The concept has been defined in many ways. 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. (Hasan& Butt, 2009).

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 EARLIER STUDIES

Several studies have examined the relationship between corporate governance and firm performance. Most of them suggested positive correlation. But despite the intuition that good governance leads to good performance by firm, there has been lack of conclusive evidence on this linkage and the results have been mixed bag **Charreaux and Desbrières (2001)**[1] discuss a very crucial point of difference between stakeholder value and shareholder value. **Gompers et al. (2003)**[2], who further found that firms with stronger governance structure and shareholder rights enjoy higher firm value, profits and sales growth.**(Pande,2011)**.**Brown and Caylor (2004)**[3]determined that board composition was the most important driving factor among the core factors of Corporate Governance Quotient (CGQ). They also found positive correlation between industry-adjusted CGQ scores and financial performance measures - shareholder returns, profitability, and dividend payouts and yields.**Lacker, Richardson and Tuna (2004)**[4] in their working paper series on importance of Corporate Governance, examine the relation between a broad set of corporate governance factors and various measures of organizational behavior and managerial performance. Through their empirical research they find that typical structural indicators of corporate governance have very limited ability to explain managerial behavior and organizational performance.

Van de Velde et al. (2005)[5]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)**[6]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)[8]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 overall corporate governance and disclosure practices in select sample companies.
b) To study the factors influencing corporate governance practices in the selected corporate sectors
c) To identify the impact of corporate governance on financial performance of companies.

IV. SCOPE OF THE STUDY

This study will help us to know whether nature of industry is associated with corporate governance and disclosure practices of companies in India.

V. RESEARCH GAP

Review of Literature on Corporate Governance reveals that the studies undertaken in the past cover differences in codes of Best Practices prepared by different committees and bodies in different countries, role of non-executive directors, impact of pattern of share-holding on performance, relationship between Board size and performance of the corporate, role of creditors, governance in public enterprises and aspects having impact on quality of governance. However, the 'empirical work' to test the relationship between extent of adoption of corporate governance practices, its relationship with size of the firm or its performance is scanty.

VI. LIMITATIONS OF THE STUDY;

The present study is subject to certain limitations. Firstly the sample size is 25 companies. Secondly, the period is covered only for 5 years based on secondary sources. Hence the accuracy and quality of the results may vary if one takes several factors into account and larger samples of data.

VII. RESEARCH METHODOLOGY

The sample for the study was collected from the listed companies in India. These samples are selected from the published issue of the "Business Today – November 2013" titled India's Top 500 companies in terms of market capitalization. The top 500 companies are segmented into 24 sectors. Among these 24 sectors, 5 sectors selected through random sampling method which includes top 25 companies in terms of highest market capitalization.The select 5 sectors includeTop five IT, Pharma, Manufacturing, Automobile and overall top 5 companies. The Annual Reports of 25 companies for the period ending March 2014 or December 2013 (based on firm's financial year) have been downloaded from the company websites and moneycontrol.com.

VIII. CORPORATE GOVERNANCE DISCLOSURE (CGD) SCORE

As per Clause 49 of SEBI listing agreement, firms have to mandatorily disclose their corporate governance practices as per the guidelines stipulated by them. All Indian listed companies to file with SEBI the corporate governance compliance report along with financial statements. Therefore there is a need to develop a methodology for measuring voluntary corporate governance disclosure practices, as mandatory disclosure is already taken care by Clause 49. 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 this study, only the annual report information is used for calculating corporate governance and disclosures (CGD) score of companies. The annual reports of the selected 25 companies were examined for the financial year 2013-14. 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.On this basis the researcher has developed corporate governance disclosure index with the following formula.

$$\text{Corporate governance index}^* = \frac{\text{Total disclosure}}{\text{Maximum disclosure}} \times 100$$

(Source:Chartered Secretary Journal)

Thus total actual scores obtained for corporate governance (CG) practices in respect of 52 parameters for all companies the researcher has also classified as per below group.(Table:1)

Table:1 – Ranking of CGD Score

CG Index Scores	Category	Rank
Above 82%	Best CG Index companies	1
74% - 81%	Moderate CG Index companies	2
Less than 73%	Below average CG Index companies	3

Source: Author's own calculation

IX. Impact of Corporate Governance on financial performance of the companies:

In our present study, the researcher has attempted to link the corporate governance practices with financial performance of the selected sample companies. For this, the researcher has selected 12 different variables of financial performance which are identified as dependent variables to understand the impact of corporate governance parameters on them. These included,Total Turnover (TT), Profit after tax (PAT), Return on Asset (ROA), Debt-Equity Ratio (D/E ratio), Earnings per share (EPS), Total Debt (TD), Total Assets (TA), Market Capitalization (M-Cap), Interest Coverage Ratio(IC ratio), Return on Capital Employed (ROCE), Tobin's Q (TQ) and Share price.

X. Methods of Analysis & Data collection:

The researcher has collected the above financial data from the Annual Reports of 50 companies covered under the study for the period from 2009-10 to 2013-14 and average of the above five year's data considered for the purpose of analysis.After the above exercise, the researcher has applied 3 ranking method by considering maximum, average &minimum, Three score points given for the highest numerical value, two score points for average numerical value and one score points for the lowest numerical valueof each financial variable. (The benchmarks of each financial variables and its description has been given in Appendix-B). Thus the financial performance score arrived by adding the scores of 12 financial variables for individual companies with the formula viz., Total Actual score divided by the total Expected score.Thus derived score has been classified as per below group.

Table:2 – Ranking of Financial performance Score

Financial performance Scores	Category	Rank
Above 66%	Best financial performance	1
57% - 65%	Moderate financial performance	2
Less than 56%	Below average financial performance	3

Source: Author's own calculation

XI. FINANCIAL PERFORMANCE Vs CORPORATE GOVERNANCE PRACTICES:

After classifying both for corporate governance practices and financial performance of companies, the researcher has identified 9 possible mix combinations to link the financial performance with corporate governance performance of the companies for better evaluation.

Hence the researcher has further attempted to match the performance companies with corporate governance index companies based on the ranking method and following are the matched cases and respective scores obtained for 9 possible mix combinations given in Table:3

Table:3 – Financial performance Vs CGD Score

Sl No	Mix combination	No of Companies Matched	Score
1	Best Performance with Best Corporate Governance Index	3	12%
2	Best Performance with Moderate Corporate Governance Index	2	8%
3	Best Performance with below average Corporate Governance Index	-	-
4	Moderate Performance with Best Corporate Governance Index	6	24%
5	Moderate Performance with Moderate Corporate Governance Index	4	16%
6	Moderate Performance with below average Corporate Governance Index	1	4%
7	Below average Performance with Best Corporate Governance Index	2	8%
8	Below average Performance with Moderate Corporate Governance Index	3	12%
9	Below average Performance with below average Corporate Governance Index	4	16%
	Overall	**25**	**84%**

Source:Author's own calculation

XII. ANALYSIS & MAJOR FINDINGS

We make the following findings from the observation of data given in the above Table-3

- It is found that 24% of the companies performed best when the practice moderate to best corporate governance
- Further 54% of the companies have moderate corporate governance and achieved moderate performance
- The impact of moderate to best corporate governance and below average is found to be among 44% of companies.

Therefore the efficiency of corporate governance over performance of companies is found to 57% which is greater than 50%. Hence the researcher sharply estimates that corporate governance on the whole creates 57% influence over performance of the companies.

It is found that 10% of companies having best corporate governance practices with below average financial performance. 19% of the companies practices below average corporate governance and earned below average financial performance. It is revealed that in Indian economy scenario there are some other external factors other than corporate governance contributes 10% over financial performance.

XIII. CONCLUSION

Nowadays, disclosure about corporate governance is a fundamental theme of the modern corporate regulatory system, which encompasses providing information by a company to the public in a variety of ways. Disclosure of information in annual report involves significant costs, but firms have to disclose certain items of information due to mandatory regulations. Some firms may disclose more information than what required by law. Such firms reap the benefits of disclosure to exceed the costs. In this research, a few number of companies' (RIL, Dr.Reddy, ONGC, Mahindra & Mahindra etc) disclosure levels are beyond the requirements of the revised Clause 49.

From the above table, it is found that the Best performance with best and moderate corporate governance practices is possible and best financial performance with below average corporate governance Indexis not at all possible in corporate sector in India. Hence it is profoundly concluded that to have moderate performance to best performance, companies should have moderate to best corporate governance practices. The study also revealed that best corporate governance practices ensures moderate performance to best performance in most of the companies.

XIV. RECOMMENDATIONS:

We find that corporate governance and corporate financial performance are linked and governance rating of company has significant positive impact on its financial performance. This research finding may support decision of company to improve its governance structure. Companies should strive to improve its performance along indicators of good governance – Leadership Ethics, Board Independence, Executive Compensation, Stakeholder Engagement, and Compliance with law in true letter and spirit. Companies should understand that improving governance and sustainability performance is as important as improving the financial performance.

APPENDIX-A –LIST OF COMPANIES SELECTED FOR THE STUDY

Sl No	Name of Company	Industry Type	Financial Performance Score %	CGD Score %
1	Tata Consultancy Services	IT	75	77
2	Reliance Industries Ltd	Oil & Gas	67	88
3	ITC	FMCG	64	85
4	ONGC	Oil & Gas	75	87
5	Coal India	Metal	64	73
6	Sun Pharmaceuticals	Pharma	47	65
7	Dr. Reddy's Laboratories	Pharma	58	88
8	Lupin Technologies	Pharma	56	75
9	Cipla Ltd	Pharma	50	71
10	Glaxo Smith Kline	Pharma	61	77
11	Tata Motors Ltd	Auto	47	85
12	Mahindra & Mahindra	Auto	61	87
13	Bajaj Auto	Auto	69	81
14	Maruti Suzuki	Auto	58	87
15	Hero Motocorp	Auto	69	87
16	Wipro	IT	58	85
17	Tech Mahindra	IT	56	81
18	Mphasis	IT	56	73
19	MindTree	IT	58	81
20	VakrangeeSoftwares	IT	47	67
21	Ultratech Cement	Cement	58	81
22	Hindustan Zinc	Metal	56	81
23	NMDC	Metal	56	87
24	Asian Paints	FMCG	64	75
25	BHEL	Capital goods	58	87

Source: Annual Reports& Computed data

APPENDIX-B – TAXONOMY OF FINANCIAL VARIABLES:

Sl No	Financial Parameters	Explanation	Benchmarks
1	Turnover	Amount sold by company over an year	Higher turnover would be better (ie.,numerically higher is better)
2	PAT (Profit After Tax)	Sales minus Total cost minus Tax	Higher profit would be better. (ie.,numerically higher is better)
3	Return on Assets (ROA)	It is an indicator how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. ROA=Net Income/Total Assets. Net Income means "after tax income".	The higher the ROA ratio is the better because the company is earning more money on less investment. (ie.,numerically higher is better)
4	Debt-Equity Ratio (D/E ratio)	This is an indicator of financial leverage. It compares assets provided by creditors to assets provided by shareholders. D/E = Total Liabilities / Shareholders' Equity	Lower value of Debit Equity ratio are favorable indicating less risk. (ie.,numerically lower is better)
5	Earnings Per share (EPS)	This is the company's average annualized profit divided by its number of outstanding shares per year. In calculating EPS, the company often uses a weighted average of shares outstanding over the reporting term.	Higher EPS is always better than a lower ratio because this means the company is more profitable and the company has more profits to distribute to its shareholders. (ie.,numerically higher is better)

Sl No	Financial Parameters	Explanation	Benchmarks
6	Total Debt	Amount owned by the company for funds borrowed. It includes short-term debts and long-term debts.	Lower is always better. (ie.,numerically lower is better)
7	Total Assets	It includes all assets that have value in exchange. It contains both fixed assets and current assets.	Higher is the better. (ie.,numerically is better)
8	Market Capitalization	The total currency value of all outstanding shares. It is computed as shares times' current market price. It is a measure of corporate size.	Higher the stock price, the larger the company. Historically, larger caps have experienced slower growth with lowest risk and smaller caps experience higher growth potential, but with higher risk. (ie.,numerically higher is better)
9	Interest Coverage Ratio (ICR)	Interest Coverage Ratio measures the ability of the company to pay the interest on its outstanding debt. (Interest Coverage Ratio= EarningsBefore Interest &Taxes(EBIT) / Interest Expense)	Higher ratio (or 2:1) indicates that a company is sufficient to pay the interest expense. (Numerically higher is better)
10	ROCE (Return on Capital Employed)	This is used as a measure of returns that a company is realizing from its capital employed. Capital employed is represented as total assets minus current liabilities. ROCE is a ratio that indicates the efficiency and profitability of a company's capital investments (which includes stocks, shares and long term liabilities). ROCE=EBIT/Total Assets - Current Liabilities.	It indicates how well a company is using both its equity and debt to generate return. Higher the ratio would be better. (ie.,numerically higher is better)

Sl No	Financial Parameters	Explanation	Benchmarks
11	Tobin's Q	Tobin's Q= Total Debt/Total Assets +Market Cap./Total Assets	A low "Q" (between 0 and 1) means that the cost to replace a firm's assets is greater than the value of its stock. It implies that that stock is undervalued. Conversely, a high "Q" (greater than 1) implies firm's stock is more expensive than the replacement cost of its assets, which means stock is overvalued. (ie.,numerically closer to “1” is better)
12	Share Price	The share price as on the date of closing of the financial year.	Higher the share price indicates creating wealth for its shareholders. (ie.,numerically higher is better)

APPENDIX C: LIST OF ABBRIEVATIONS:

CGD – Corporate Governance Disclosure

CGQ – Corporate Governance Quotient

ROE – Return on Equity

ROA – Return on Asset

CSR – Corporate Social Responsibility

EPS – Earning per share

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List of websites:

1. Annual Reports downloaded from respective websites of sample companies
2. http://www.moneycontrol.com
3. http://www.ssrn.com
4. http://www.icsi.edu
5. http://www.icmai.in
6. http://www.pwc.in