DOES BETTER CORPORATE GOVERNANCE LED TO GOOD FINANCIAL PERFORMANCE?

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Abstract: ***The concept of corporate governance has gained importance in the recent past. To get a fair view on the subject it would be prudent to give a narrow as well as a broad definition of corporate governance. In a narrow sense, corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. Empirical studies have been conducted in various countries on whether there is any link between the corporate governance / board composition and corporate performance. Much of the previous literature has shown a positive relationship between governance and firm performance. The broader objective of this research paper is to understand the Corporate Governance processes of Indian Companies and to see the impact of Corporate Governance on the Financial Performance.***

Keywords: ***Corporate governance, auditors, stakeholders, corporate performance***

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1. Corporate Governance: The Concept

The concept of corporate governance has gained importance in the recent past. To get a fair view on the subject it would be prudent to give a narrow as well as a broad definition of corporate governance. In a narrow sense, corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide

the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders.

In a broader sense, however, good corporate governance- the extents to which companies are run in an open and honest manner- is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries' industrial bases, and ultimately the nations' overall wealth and welfare.

It is important to note that in both the narrow as well as in the broad definitions, the concepts of disclosure and transparency occupy centre-stage. In the first instance, they create trust at the firm level among the suppliers of finance. In the second instance, they create overall confidence at the aggregate economy level. In both cases, they result in efficient allocation of capital.

Here, the question arises is 'Who should corporate governance really represent?' This issue of whether a company should be run solely in the interest of the shareholders or whether it should take account the interest of all constituents has been widely discussed and debated for a long time now. Two definitions of Corporate Governance highlight the variation in the points of view:

'Corporate governance is concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors'(Mayor,1997) Corporate governance includes 'the structures, processes, cultures and systems that engender the successful operation of organizations' (K. Keasey, S. Thompson and M. Wright ,1997)

The issue raised here is whether the recognition of claims of a wider set of stakeholders, than those of shareholders alone, is the legitimate concern of corporate governance. If it can be established that there are groups other than shareholders with legitimate claims on companies, and that their involvement in corporate decision making is both a right and is also economically beneficial, then the task of policy makers is to consider: 'How should the company be regulated so as to enhance its effectiveness as a mechanism for enhancing the overall wealth or well-being of all stakeholders?'

2. Corporate governance: Recent Developments in India

There are several developments in corporate sector at national and international level which indicate that a detailed study is required in corporate governance area. If we look into history, there are several attempts made by Government and various trade associations for systematic development of Corporate Governance.

• The first attempt was made by Confederation of Indian Industries (CII), which came out with 'CII Code on Corporate Governance' in 1997-98.

• The second attempt was by Securities and Exchange Board of India (SEBI) in 1999, which appointed Kumar Mangalam Birla Committee2 and upon its recommendation, SEBI incorporated Clause 49 of Listing Agreement.

• In 2002 the Department of Company Affairs, Government of India appointed a committee under chairmanship of Shri Naresh Chandra to examine various Corporate Governance issues.

• The fourth initiative on corporate governance in India is in the form of the recommendations of the Narayana Murthy committee. The committee was set up by SEBI, under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49, and suggest measures to improve corporate governance standards.

• More recently, in 2009, CII constituted a committee under the chairmanship of Shri Naresh Chandra to improve the corporate governance standards in India.
• In December 2009, the Ministry of Corporate Affairs (MCA) published a new set of “Corporate Governance Voluntary Guidelines 2009” , designed to encourage companies to adopt better practices in the running of boards and board committees, the appointment and rotation of external auditors, and creating a whistle blowing mechanism.
• Securities and Exchange Board of India has also incorporated various corporate governance practices as a part of listing agreement (Clause 49).

3. Review of Literature

Empirical studies have been conducted in various countries on whether there is any link between the corporate governance / board composition and corporate performance. Some researchers had looked for a direct evidence of a link between board composition and corporate performance. Many foreign researchers have tried to study the correlation between the Corporate Governance and firm’s performance. Much of the previous literature has shown a positive relationship between governance and firm performance assuming that governance is an independent regressor, i.e. it is exogenously determined, in a firm performance regression. This would suggest that firms are not in equilibrium, and improvements in governance would lead to improvements in firm performance. On the other hand, Demsetz and Lehn (1985) , among others, have shown that governance is related to *observable* firm and CEO characteristics. Studies have generally examined three characteristics of boards, namely, the size of the board, proportion of outsiders on the board, and the number of board meetings.
Among studies that assume board characteristics are exogenously determined, Jensen (1993) , Yermack (1996) , Eisenberg, Sundgren, and Wells (1998) , and Mak and Kusnadi (2002) find that small size boards are positively related to high firm value, Baysinger and Butler (1985) , Mehran (1995) , and Klein (1998) find that firm value is insignificantly related to a higher proportion of outsiders on the board, and Vafeas (1999) and Adams and Ferreira (2004) find that firm value is increased when boards meet more often. Accordingly, good governance changes are defined when the board got smaller, the proportion of outsiders in the board were increased, and when the number of board meetings increases.
However, many theoretical and empirical studies have suggested board characteristics are endogenously determined and that board size and composition varies with firm characteristics (see, Kole and Lehn 1999 , Mak and Rousch 2000 and Adams (2005).
The relation between the proportion of outside directors, a proxy for board independence, and firm performance is mixed. Studies using financial statement data and Tobin’s Q find no link between board independence and firm performance, while those using stock returns data or bond yield data find a positive link. Consistent with Hermalin and Weisbach (1991) and Bhagat and Black (2002) , we do not find Tobin’s Q to increase in board independence (in fact, we find the opposite), but we do find that firms with independent boards have higher returns on equity, higher profit margins, larger dividend yields, and larger stock repurchases, suggesting that board independence is associated with other important measures of firm performance aside from Tobin’s Q.
Limiting board size is believed to improve firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision-making of larger groups (Lipton and Lorsch 1992) . Consistent with this notion, Yermack (1996) documents an inverse relation between board size and profitability, asset utilization, and Tobin’s Q. Anderson (2004) show that the cost of debt is lower for larger boards, presumably because creditors view these firms as having more effective monitors of their financial accounting processes.
Several studies have examined the separation of CEO and chairman, positing that agency problems are higher when the same person holds both positions. The question of how corporate governance and board characteristics such as composition or size or quality related to profitability or performance are still remains unresolved. Yet, the recommendation of the Securities and Exchange Board of India committee on Corporate Governance under the Chairmanship of Kumar Mangalam Birla (1999) , the Confederation of Indian Industry (CII) code on Corporate Governance (1999) , The Naresh Chandra Committee (2002) and the Securities and Exchange Board of India Committee on corporate Governance under the Chairmanship of N R Narayanamurthy (2003) are in favour of improving the corporate governance scenario in India by favouring majority – independent director’s board. However, the J J Irani Committee has recommended 33 per cent independence, which can also vary with the size and type of organization. Support for a link between good governance practice and shareholder returns was also found in research conducted by Governance Metrics International. Following on from the research by Gompers et al, Bebchuk et al (2004) investigated which of the 24 governance provisions tracked by the IRRC.

4. Objective of the Study

The broader objective of this research is to understand the Corporate Governance processes of Indian Companies and to see the impact of Corporate Governance on the Financial Performance.

5. Methodology

As a part of this study, the researcher is required to calculate various scores in the area of financial performance and Corporate Governance.

5.1 Ratios (For measuring the Financial Performance)

To evaluate a financial performance has been a difficult task for any researcher. However we have considered the following ratios as key financial performance indicator. There are several parameters to evaluate any financial statement. However as the focus of the research is on Corporate Governance, the following financial parameters are considered. They are as under :
i) EBT / Sales
ii) Sales / Total Assets
iii) Earning Per Share

iv) P/E Multiple

5.2 Questionnaire (For estimating Corporate Governance Code)

The present study aims to examine the governance practices prevailing in the corporate sector within the Indian regulatory framework. The study is conducted to assess governance practices and process followed by Indian corporate houses. The study also aims to assess the substance and quality of reporting of Corporate Governance practices in annual reports. The study aims to evaluate the state of compliance of various governance parameters in these companies. The parameters include the Statutory and Non mandatory requirements stipulated by revised Clause 49 of the listing agreement as prescribed by Securities and Exchange Board of India (SEBI) and relative amendments in the Companies Act, 1956.

Table-I Questionnaire (For estimating Corporate Governance Code)

No.		Governance Parameters	Points / Score Assigned	
1		Statement of Company's philosophy on code of governance		2
2		Structure and Strength of board		2
3		Chairman & CEO Duality	Max	5
	i	Promoter Executive Chairman - Cum - MD / CEO	1	
	ii	Non promoter Executive Chairman cum MD / CEO	2	
	iii	Promoter Non Executive Chairman	3	
	iv	Non Promoter Non Executive Chairman	4	
	v	Non Executive Independent Chairman	5	
4		Disclosure of Tenure and Age limit of directors		2
5		Disclosure of :		3
	i	Definition of Independent Director	1	
	ii	Definition of Financial Expert	1	
	iii	Selection Criteria of Board of Directors incl. independent directors	1	
6		Post Board meeting follow up system and compliance of the board procedures		2
7		Appointment of lead independent director		2
8		Disclosure of other provision as to the boards and committees		1
9		Disclosure of :		2
	i	Remuneration Policy	1	
	ii	Remuneration of Directors	1	
10		Code of Conduct		2
	i	Information on Code of Conduct	1	
	ii	Affirmation of compliance	1	
11		Audit Committee		8
	i	Transparency in composition of audit committee	1	
	ii	Compliance of minimum requirement of the number of independent directors in the committee	1	
	iii	Compliance of minimum requirement of the number of meetings of the committee.	1	
	iv	Information about literacy & expertise of committee members.	1	
	v	information about participation of head of finance, statutory auditor and chief internal auditor in the committee meeting	2	
	vi	Disclosure of audit committee charter and terms of reference	1	

	vii	Publishing of audit committee report	1	
12		General Body Meetings		3
	i	Location and time of general meetings held in last three years	1	
	ii	Details of Special Resolution passed in last three AGMs \ EGMs	1	
	iii	Details of resolution passed last year through postal ballot incl. conducting official and voting process	1	
13		Means of communication and General shareholder information		2
14		CEO / CFO Certification		4
15		Disclosure of Stakeholders' interests :		10
	i	Environment, Health & Safety Measures (EHS)	2	
	ii	Human Resource Development Initiative (HRD)	2	
	iii	Corporate Social Responsibility (CSR)	2	
	iv	Industrial Relation (IR)	2	
	v	Disclosure of policies on EHS, HRD, CSR & IR	2	
		Total		50

Source: Securities and Exchange Board of India (SEBI)

5.3 Evaluation of Governance Standard.

After analysis of governance structure, process and disclosures made on corporate governance, the question comes to mind is what is the standard and quality of governance that has been achieved by various companies?

Table-II Evaluation of Governance Standard.

Score Range	**Rank**
40 - 50	Excellent
30-40	Very Good
20 -30	Good
10 - 20	Average
Below 10	Poor

Considering the fact that there have been certain genuine difficulties because of non availability of inside information, no scope for discussion with key officials of these companies, their auditors – internal auditors, directors and major shareholders etc. as an alternative, it is developed as a working method, which is described in the above table. It was designed on the basis of Clause 49 of the listing agreement. This point based method gives weight-age to various components and ultimately, each of these companies has been awarded different points on key parameters.

5.4 SAMPLE OF THE STUDY

In the present study, the telecom sector has been chosen. Keeping in view the reach of the researchers, the following 5 telecom companies have been selected:

Table-III SAMPLE OF THE STUDY

Sr. No.	Company	Abbreviation
1	Bharti Airtel Ltd.	BAL
2	Idea Cellular Ltd	ICL
3	Mahanagar Telephone Nigam Ltd.	MTNL
4	Reliance Communications Ltd.	RCL
5	Tata Communications Ltd.	TCL

6. Corporate Governance Score for Telecom Sector

After a series of meetings with the key officials of the concerned companies and after careful observations of their published documents, the following corporate governance scores have been assigned.

Table: IV Corporate Governance Score for Telecom Sector

No.	Governance Parameters	No.	Bharti	Idea	MTNL	Rel	Tata
1	Statement of Company's philosophy on code of governance	2	2	2	2	2	2
2	Structure and Strength of board	2	2	2	2	2	2
3	Chairman & CEO Duality	5	1	3	2	3	5
4	Disclosure of Tenure and Age limit of directors	2	2	2	0	2	2
5	Disclosure of :	3	2	0	0	0	1
6	Post Board meeting follow up system and compliance of the board procedures	2	0	0	0	0	0
7	Appointment of lead independent director	2	2	0	0	0	0
8	Disclosure of other provision as to the boards and committees	1	1	1	1	1	1
9	Disclosure of :	2	2	2	2	2	2
10	Code of Conduct	2	2	2	2	2	2
11	Audit Committee	8	8	7	4	7	6
12	General Body Meetings	3	3	3	3	3	3
13	Means of communication and General shareholder information	2	2	2	2	2	2
14	CEO / CFO Certification	4	4	4	4	4	4
15	Disclosure of Stakeholders' interests :	10	4	2	2	2	2
	Total	50	37	32	26	32	34
	Rank		1	3	5	3	2

Source: Assigned by the researcher

6.1 Analysis of Corporate Governance Score of Telecom Industry

1. Statement of Company's philosophy on code of governance
In the Telecom sector there are 4 sample companies, as mentioned earlier, the first score point having a weightage of 2 was, statement of Company's philosophy on Corporate Governance All companies get the expected score of 2 as all companies have sufficient disclosure of the statement of Company's philosophy on code of governance.
2. Structure and Strength of board
In the Corporate Governance score, the second score point was about the Structure and Strength of the board having a weightage of 2. All companies get the expected score of 2. All companies have sufficiently disclosed the composition of the Board of Directors.
3. Chairman and CEO Duality
As mentioned earlier, this point carries a weightage of 5. TCL is assigned a score of 5 as it is having Non Executive Independent Chairman. REL and ICL are having a Promoter Non Executive Chairman hence they are assigned a score of 3. MTNL is having a Non promoter Executive Chairman cum MD, it is assigned a score of 2. BAL is having promoter Executive Chairman and is assigned a score of 1.
4. Disclosure of Tenure and Age limit of directors
As mentioned earlier, this point was assigned a weightage of 2. All companies (except MTNL) have sufficiently provided the details of this section. Hence, they get the expected score ossf 2. MTNL gets Zero score in this section.
5. Disclosure of Definition and selection criteria for (Independent) Directors
As mentioned earlier, this point was assigned a weightage of 3. BAL have disclosed details about one of the definitions, whereas TCL and BAL have disclosed has selection criteria for board members. Therefore BAL is assigned a score of 2 whereas TCL gets 1 and remaining companies get a zero score.
6. Post Board meeting follow up system and compliance of the board procedures This point was assigned a weightage of 2. The systematic disclosure about the Post Board meeting follow up system is not sufficiently available in any annual report of the sample companies. Hence, none of the sample companies could get any point in this section.
7. Appointment of Lead Independent Director
This point is about appointment of lead independent director and carries a weightage of 2. Among the sample, BAL has appointed lead independent director. Hence, BAL gets a score of 2 whereas other sample companies could get any point in this section.
8. Disclosure of other provision as to the boards and committees
It is observed that all companies have sufficiently disclosed about the various committees and sub-committees of the board. Hence, all companies get expected score.
9. Disclosure of Remuneration Policy & Remuneration of Directors
This point is about the disclosure of Remuneration Policy & Remuneration of Directors and it carries a weightage of 2. All sample companies have sufficiently disclosed about remuneration to directors and remuneration policy. Hence they are assigned a score of 2.
10. Code of Conduct
As mentioned earlier, this point is about code of conduct and carries a weightage of 2. The point was further equally divided into two points,
(i) Information on Code of Conduct and
(ii) Affirmation regarding compliance for code of conduct.

It is observed that all the companies have sufficiently disclosed about both the above points. Hence, all companies get expected score of 2.

11. Audit Committee

The Audit Committee is assigned a weightage of 8. It is observed that all companies (except MTNL) have made sufficient disclosure about the audit committee. The MTNL have not complied with of minimum requirement of the number of independent directors in the committee. It had also not provided information about information about participation of head of finance, statutory auditor and chief internal auditor in the committee meeting. TCL have not adequately disclosed about audit committee charter and terms of reference. Other sample companies have sufficiently disclosed committee charter and terms of reference. However, none of among the sample companies (except BAL), have published Audit Committee Report in the annual report. Hence, BAL gets expected score of 8, ICL and RCL gets a score of 7, TCL gets a score of 6 and MTNL gets a score of 4.

12. General Body Meetings

This point was about the General Body Meetings, carrying a weightage of 3. All companies have sufficiently disclosed about the various points related to General body meetings in the annual report. Hence, all sample companies get the expected score of 3.

13. Means of communication and General shareholder information

The 13th score point was disclosure about the means of communication and general shareholder information and carries weightage of 2. All sample companies have sufficiently disclosed about the point in the annual report. Hence, all companies get the expected score of 2.

14. CEO / CFO Certification

The 14th score point was about the certification of CEO \ CFO, carrying a weightage of 2. It is observed that all companies have certification from CEO \ CFO. Hence, all companies get the expected score of 2.

15. Disclosure of Stakeholders' interests :

The 15th score point was about the disclosure of the stakeholders' interest and was assigned a weightage of 10. This point is divided equally to the following.

i) Environment, Health & Safety Measures (EHS)
ii) Human Resource Development Initiative (HRD)
iii) Corporate Social Responsibility (CSR)
iv) Industrial Relation (IR)
v) Disclosure of policies on EHS, HRD, CSR & IR

It is observed that most of the companies have provided information about above mentioned points in various forms. EHS, HRD, CSR & IR policies are not disclosed adequately in the report of any sample companies. All sample companies have sufficiently provided details about HRD. Whereas CSR related activities are adequately mentioned in BAL balance sheet. Therefore, BAL gets the score of 4 whereas other sample companies get a score of 2.

7. Evaluation of the Financial Performance.

The following parameters are used to analyze the financial performance for this research.

a) EBIT / SALES Ratio:

This ratio is used to analyze the operational efficiency of the company and the sector. This ratio also indicates the impact of sales on Earnings Before Interest and Taxes.

b) SALES / TOTAL ASSETS :

Assets are used to generate sales. Therefore, a firm is required to manage the assets with adequate efficiency to maximize sales. The relationship between Sales and Total Assets is known as Total Assets Turnover. A high ratio indicates better utilization of investments made in assets. However, it ultimately depends upon industry.

c) Earnings Per Share :

Earnings Per Share is net profit divided by number of equity shares. This indicates earnings earned by company per share during the year. A high EPS indicates better performance. However, one has to consider the face value of the share as it varies from Rs. 1 to Rs. 10.

d) Price Earnings Multiple :

This is one of the most popular among the financial analysts to value the firm's performance as expected by the shareholders. This can be calculated as under :

P/E Ratio = Market Value Per Share \ EPS

This ratio indicates investors' expectations about the firm's performance & It also reflects investors' expectations about the growth in the firm's earnings.

Table V Financial Performance of Sample Companies in Telecom Sector

Sr. No.	Company	EBT / SALES	SALES/TA	EPS	P/E
1	Bharti Airtel Ltd.	27%	0.95	32.91	21.46
2	Idea Cellular Ltd	17%	0.58	3.96	22.47
3	Mahanagar Telephone Nigam Ltd.	12%	0.43	9.32	9.95
4	Reliance Communications Ltd.	19%	0.30	12.60	37.78
5	Tata Communications Ltd.	13%	0.47	10.68	41.20
Industry Average		18%	0.55	**13.89**	**26.57**
Aggregate average		20%	1.24	45.46	13.19

Source: computed from the annual reports of Companies for the year 2010-11. Industry average is taken from moneycontrol.com

The following facts can be revealed from above mentioned table.
i. Average EBT/Sales ratio of the industry is almost 18 % the average EBT/Sales ratio is lower than compared to aggregate of all companies, which is 21%. The Bharti Airtel Ltd. is having highest ratio of 27 % whereas MTNL is having lowest ratio of 15 %.
ii. Sales/ Total Assets ratio of the industry is 0.55 times, which is lower than aggregate of all companies, which is 1.22 times. Bharti Airtel Ltd. Carries highest ratio of 0.95 whereas Reliance Communications Ltd. carries ratio of 0.30 which is lowest in the industry.
iii. Earnings Per Share (EPS): The average EPS of the industry is Rs.13.89 which is lower than aggregate of all sample companies which is Rs. 45.46. The EPS of Bharti Airtel Ltd. is highest at Rs. 32.91 whereas that of Idea Cellular Ltd. is lowest at Rs. 3.96.
iv. The Price Earning Multiple is also a significant indicator for potential investor. As mentioned in the above table, the Industry's average PE at 26.57 while aggregate of PE of 13.19. The PE of Tata Communications Ltd. is highest at 41.20 while MTNL Ltd. is lowest at 9.95.
For further analysis, correlation is also calculated in context of Corporate Governance Score.

Table VI: Correlation between Financial Performance and
Corporate Governance for the sample companies in Telecom Sector

	DIR	BC	TD	GI	EBT / SALES	SALES/TA	EPS	P/E
DIR	1.00							
BC	0.81	1.00						
TD	0.56	0.89	1.00					
GI	0.84	0.98	0.81	1.00				
EBT / SALES	0.40	0.70	0.68	0.75	1.00			
SALES/TA	0.40	0.39	0.10	0.54	0.73	1.00		
EPS	0.41	0.43	0.39	0.53	0.85	0.77	1.00	
P/E	0.71	0.64	0.66	0.54	0.01	-0.33	-0.07	1.00

8. Conclusion

The following conclusions can be revealed from above mentioned table.
i) Director's related disclosure is positively related with all corporate governance parameters. It is also positively associated with all financial performance parameter. Its relation with P/E is more significant.
ii) Board Committees related disclosure is positively related with all Corporate Governance parameters, it is also negatively related with all financial parameter. It is significantly associated with EBT/Sales.
iii) Transparency Disclosure is positively related with all Corporate Governance related parameters. It is also negatively related to all financial performance related parameter. It is also significantly related with EBT/Sales and P/E.
iv) General Information related disclosure is positively related with all Corporate Governance related parameters. It is also positively related with all financial performance related parameter, more particularly, EBT/Sales.
v) P/E is negatively related with all two financial parameters i.e. Sales/TA and EPS.
vi) EBT/Sales is significantly positively related with two corporate governance parameters Board Composition parameters (Board Composition and General Information disclosure).

So., enough evidence has been found regarding a positive relationship between good corporate governance and good financial governance.

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