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Corporate Governance in India - An Economic Analysis

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Abstract

This study contributes to the existing literature by using the Ohlson (1995) pricing model as a measure to capture earnings management between related parties in Indian firms, but it has a few limitations. India lacks measures of corporate governance, and this study used corporate governance ratings of the top 500 companies as a proxy for corporate governance practices in Indian firms. A comprehensive measure of governance practices needs to be developed for Indian firms.Companies manipulate earnings (Jian and Wong 2010; Goel 2016). The Enron and WorldCom scandals in the United States, and the collapse of Satyam Computer Services in India, which cost Indian shareholders $1.47 billion, focused the attention of researchers on earnings management practices and raised alarm over the quality of the reported earnings of Indian corporate houses and business groups and the effectiveness of corporate governance mechanisms in India (Ajit et al 2013; Bertrand et al 2002). In its value relevance equation, this study used ARPT as a proxy for earnings management; however, to understand how earnings management impacts value relevance, other earnings management measures need to be studied. Many emerging economies are slowly migrating to the IFRS or IFRS-equivalent practices, and it would be interesting to explore whether this migration has improved reporting standards. Future studies can address some of these limitations. The conduct of the Reserve Bank of India?s monetary policy in the 1990s has shaped and in turn, been shaped by the programme of financial sector reforms. The operating procedure of monetary policy had to be comprehensively recast to enable the shift from direct to indirect monetary policy instruments in consonance with the increasing market orientation of the economy. This paper examines the impact of financial sector reforms on the balance sheet of the RBI. In the wake of financial sector reforms, we find that a regime switching has taken place in the RBI?s asset size as well as in the size of its surplus. Moreover, the RBI Balance Sheet has become more transparent in line with international accounting standards. The fundamental work on the relationship between accounting earnings and stock returns (Ball and Brown 1968), and on value relevance (Ohlson 1995), generated interest among researchers in exploring the informational content of accounting information. The focus, initially on markets in the United States, diffused to Canada and Australia (Barth and Clinch 1996) and to Europe—the United Kingdom (Alford et al 1993), France, Germany, and the Netherlands (Harris et al 1994). Researchers have focused on various aspects of earnings management, including earnings management practices by firms during initial public offering (IPO) (Aharony et al 2000), the relationship between value and performance (Arya et al 2003), and developing measures and models to estimate earnings management practices (Kothari et al 2005). Researchers have studied conflicts of interest among controlling and minority stakeholders (Shleifer and Vishny 1997)

and identified control measures to limit the practice of earnings management by emphasising on good corporate governance practices (Gao and Kling 2008; Aharony et al 2010; Sarkar et al 2008).

Key words International Accounting Standard & Indian Accounting Standard, GAAP

Introduction

Asian economies were rapidly integrating with global markets and undergoing structural change, and their inclination towards value relevance in accounting practices was even stronger. The market settings of Asian economies are unique, and their capital markets are evolving fast, and these offer governance practices and reporting standards new challenges. These changing paradigms make it imperative to pay attention to value relevance, as paying attention to value relevance may reduce informational asymmetry and minimise the adverse selection problem of investors (Lundholm and Van Winkle 2006). Does the adoption of new accounting standards increase value relevance or decrease it (Aharony et al 2010)? In 14 countries in Europe, firms that adopted the IFRS raised investor value (Aharony et al 2010). Conservative accounting practices are less value-relevant in Asian countries, including Indonesia, Malaysia, the Philippines, Taiwan, and Thailand (Graham and King 2000). Domestic investors perceive the Chinese Generally Accepted Accounting Principles as being value-relevant, although the market is young and accounting and financial reporting in China is inadequate (Chen et al 2001).

Do country-related and institutional factors affect value relevance? The internal institutional framework of countries plays a critical role in financial reporting outcomes (Ball et al 2000; Ball and Shivakumar 2005). Ball et al (2000) compare the quality of accounting earnings of countries that follow the Anglo-Saxon model of corporate governance with those of countries that follow the continental model of corporate governance; analysing two essential characteristics of accounting earnings (conservatism and timeliness), they find that timeliness is higher in the Anglo-Saxon governance model. A comparative study of the capital markets of the European Union, Japan, and the United States shows that their institutional and regulatory aspects differ and their accounting information differs significantly in value (Garcia–Ayuso et al 1998).

Objective:

This paper intends to explore Corporate Governance, accounting practices its harmonization issue, its current status, challenges with special reference to Indian perspective.

Earnings Management, and Corporate Governance in India

In emerging economies, where the shareholding model is promoter-dominated and promoters exercise substantial control, studies provide evidence of principal–principal conflicts (Shleifer and Vishny 1997; Young et al 2008). In India, about 90% of private businesses are family-owned (Merchant 2011), and principal–principal conflicts are the major cause of concern in cases where the majority stakeholding is family-owned, as legal protection for minority stakeholders is weak (Young et al 2008). Related party transactions are used to manipulate earnings (Wong et al 2015), but good governance can restrain “tunnelling,” or the expropriation of the funds and assets of all the shareholders by controlling shareholders (Shan 2013).

Studies have used the Ohlson (1995) price model and the Feltham and Ohlson (1995) price model to investigate the value and relevance of accounting information (Graham and King 2000). Most of these studies ask whether the adoption of new accounting standards increases or decreases value relevance (Aharony et al 2010); whether country-related and institutional factors affect value relevance; or what the relationship is between earnings management, value relevance, and the adoption of International Financial Reporting Standards (IFRS) or IFRS-convergent standards.

What is the relationship between earnings management, value relevance, and adoption of IFRS/IFRS-convergent standards? China has mandated that listed firms adopt IFRS-convergent standards, and the quality of earnings reporting has improved (Liu et al 2011). The controlling shareholders use related party transactions to manage earnings, which impacts financial reporting (Ajit et al 2013; Jian and Wong 2010), to inflate earnings and avoid reporting losses (Jian and Wong 2010; Rajagopalan and Zhang 2009). Lo and Wong (2011) study Chinese firms and report a negative association between voluntary disclosures of related party transactions and earnings management.

Holthausen and Watt (2001) review the literature on value relevance and posit that accounting data are informative if there is a relationship with share price or returns. Barth et al (2008) argue that earnings management and value relevance determine the quality of accounting. Good-quality accounting is positively associated with higher value relevance and negatively associated with earnings management, and a negative association is hypothesised, ceteris paribus, between earnings management and value relevance (Hypothesis 1).

Tunnelling has been shown to exist by past empirics (Gao and Kling 2008; Friedman et al 2003; Rajagopalan and Zhang 2009). In countries like India, where ownership is concentrated and the governance structure is weak, controlling stakeholders may practise earnings management by tunnelling (Ajit et al 2013). Chinese firms use related party transactions to misappropriate the assets of minority shareholders (Cheung et al 2009).

An IPO is a transition in the market, and it may incentivise earnings management before the listing; and tunnelling may be practised in the post-IPO period. Chinese firms practise tunnelling during the IPO process and to exploit economic resources at the expense of the minority shareholders, who are part of the IPO process, to benefit the parent company (Aharony et al 2010). Related party lending transfers significant amounts of cash from listed firms to controlling owners.

In emerging economies, earnings management practices pose a severe challenge. Good governance reduces the practice of earnings management (Buniamin et al 2012), and legal and regulatory reforms are needed to curb insider abuse and safeguard the minority interest (Jiang et al 2010; Rajagopalan and Zhang 2009).

One of the distinguishing characteristics of a modern corporation is the dichotomy of ownership and control (Berle and Means 1932); owners rarely participate in day-to-day activities. Agents may act in their interests against the owners' and lead a firm to practise earnings management—the "agency problem." Enforceable contracts protect owners from such conflicts of interest, but these give rise to "agency cost" (Jensen and Meckling 1976). Such conflicts of interest motivate many corporate governance studies that analyse how corporate governance can mitigate the agency problem and agency cost (Shleifer and Vishny 1997). Some of these studies corroborate that better corporate governance mechanisms reduce the practice of earnings management in companies (Sarkar et al 2008; Shan 2015). It is hypothesised that, ceteris paribus, good corporate governance mechanisms are negatively associated with earnings management (Hypothesis 2).

In attempting to understand the domino effect in terms of value relevance, earnings management, and corporate governance in India, this paper addresses two key research questions: Does the practice of earnings management affect value relevance? Do corporate governance practices limit the earnings management practice of Indian firms? In this study, earnings management is operationalised through related party transactions, which may be both normal and abnormal. Lo and Wong (2011) report incentives for using abnormal related party transactions (ARPT) for managing earnings, following the Jian and Wong (2010) model, and this study uses ARPT as a proxy for earnings management.

Data

This study uses the data for a five-year period (from 2012 to 2016) for all companies that are part of the broad-based NIFTY 500 index, which is created and maintained by the National Stock Exchange (NSE). This study extracted the corporate governance ratings from the *Bloomberg* database for these 500 companies and the data source for related party transactions from the Capitaline database. The remaining financial data are obtained from the Prowess database of the Centre for Monitoring Indian Economy. The stock prices and trade volume proxy for stock liquidity are sourced from the website of the NSE. Banks, financial service companies, and state-owned enterprises (public service undertakings) are exempt from disclosing related party transactions, and this study excludes these institutions.

Model

One of two regression models, fixed effects or random effects, may be used to determine the relationship of earnings management with value relevance and with corporate governance. The model may encounter endogeneity issues if the time-invariant factors are not controlled; however, the random effects regression model is preferred if the time-invariant factors are uncorrelated with the explanatory variables. The Hausman test confirms that the random effects model is a better fit for the current study. This study employs a random effects regression model to test the two hypotheses.

To test Hypothesis 1, or determine the relationship between earnings management and value relevance, Model 1 modifies Ohlson's (1995) pricing model and uses it.

$$Price = \alpha_i + \beta_1 BVPS_{it} + \beta_2 EPS_{it} + \beta_3 ARPT_{it} + \beta_4 EPS_{it} * ARPT_{it} + \beta_5 FR\_Size_{it} + \beta_6 Stock\_Liquidity_{it} + \beta_7 Ownership\_Pattern_{it-} + \beta_8 Industry_{it} + \nu_i + \varepsilon_{it} \quad ...(1)$$

Model 2 tests Hypothesis 2, or it attempts to determine the relationship between earnings management and corporate governance.

$$ARPT_{it} = \acute{\alpha}_i + \gamma_1 CGR_{it} + \gamma_2 ROA_{it} + \gamma_3 FR\_Size_{it} + \gamma_4 FR\_AGE_{it} + \gamma_5 Risk_{it} + \gamma_6 Ownership\_Pattern_{it} + \gamma_7 \, Competitiveness + \gamma_8 \, Industry + \acute{\upsilon}_i + \acute{\eta}_{it} \quad ...(2)$$

Dependent Variables

In Model 1, the price is the stock price of the i^{th} firm six months after the end of the financial year. All listed firms need to submit the audited financial results within six months of the end of the financial year as stipulated by both the Indian Companies Act and the Securities and Exchange Board of India (SEBI) listing agreement. The accounting literature uses price-level models predominantly to examine the value relevance of the accounting information (Beaver 2002; Ge et al 2010). The degree of earnings management in listed Indian firms is measured through ARPT, as used by Lo and Wong (2011). Analogous to accounting accruals, the level of related party transactions can be normal or abnormal (Equation 3).

First, the normal components are removed from related party transactions connected with industry classifications and firm characteristics—such as firm size, leverage, and firm growth; the ordinary least squares (OLS) method is used to remove the normal component and the residual from the OLS. Then, this study uses the residual from the ordinary regression model as a measure of ARPT.

$$TRPT_i = \varphi_i + \psi_1 Leverage_{it} + \psi_2 FR\_Size_{it} + \psi_3 MVBVE_{it} + \psi_4 Industry_{it} + \xi_{it} \quad ...(3)$$

where, *TRPT* is total related party transaction, leverage is the total debt to total equity in the firm, and *FR*_Size is the firm size measured by the natural logarithm of total assets. At the same time, market value to book value of equity (MVBVE) is the market to book value ratio, which is computed on the last day of the financial year. The industry is the industry classification based on the two-digit National Industrial Classification (NIC) code, ξ_{it} is the residual and proxy for ARPT, which are used to test the relationship between earnings management and value relevance in Equation 1 and as the dependent variable in Equation 2.

Independent Variables

Gompers et al (2003) developed the G-index to measure corporate governance, and Brown and Caylor (2006) developed Gov-Score, but these measures are nation-centric. No such measure exists for India, and this study uses the corporate governance ratings of Indian firms, part of the NIFTY 500 index, as computed by *Bloomberg*. Other independent variables are the book value of equity per share and earnings per share of the i^{th} firm in the given year *t*.

Control Variables

The firm size (FR_*Size*) is proxied by the logarithmic of total assets, the leverage (Leverage) is proxied by total debts to total equity, MVBVE is controlled, and the NIC code serves as a proxy for the industry dummy. Firm ownership pattern, measured using dummies, is controlled for both the models, as the ownership pattern affects related party transactions (Cheung et al 2009) and stock prices (Shleifer and Vishny 1997). Stock liquidity enhances the informativeness of stock prices (Foucault and Fresard 2014).

The trade volume (number of trades) is used as a proxy for liquidity in Model 1 to control for the influence of stock liquidity on stock prices. The other variables controlled for in Model 2 are return on assets (ROA), firm age, risk, and industry competitiveness. The ROA, a firm's return on an asset in a given year *t*, is measured as net operating income of i^{th} year divided by total assets i^{th} year (Shan 2015). A firm's age is measured by the number of years in business (Beatty and Zajac 1995). The risk is measured by the standard deviation. Industry competitiveness is measured by the Herfindahl index (competitiveness).

Risk, a part of the study, is a control variable because stocks of companies with good governance records tend to be stocked with high operating and financing risk (Mohanty 2003), which helps control the influence of risk on governance measures. Industry competitiveness is a control variable; it represents the competitive environment. Industry competitiveness varies by industry as companies from some industries may be reluctant to disclose certain types of private information (Jiang and Wong 2010) (Table 1).

Descriptive statistics: During the study period (2012–2016), the mean (median) corporate governance ratings for all the firms was 38.84 (44.64), the mean (median) for firm size measured in terms of logarithmic of firm assets was 24.89 (24.70), and the ROA was 6.25 (4.44). The debt-to-equity ratio proxy of a firm's financial leverage had a mean (median) of 1.06 (0.41), and the ratio of market value to book value had a mean (median) of 3.99 (2.10) (Table 2). A few key variables suffer from excess skewness and kurtosis. **Model diagnostics:** Multicollinearity problems may persist even with low correlation values (Gujarati

2009), and the validity of the regression models is tested using Pearson's rank correlation test and the variance inflation factor (Table 3). Panel A reveals that the maximum correlation among inter-item variables of the book value of equity per share and earnings per share is positively correlated at 0.65, and it is found statistically significant ($p < 0.00$), while the book value of equity per share is also negatively correlated (-0.01) to ARPT at a significant level of $p < 0.00$. Panel C in Table 3 reports a negative but statistically insignificant correlation between firm corporate governance score and ARPT, whereas ARPT is significantly and positively correlated with ROA (0.21, $p < 0.00$) and with firm age (0.17, $p < 0.00$). Panels B and D report the variance inflation factor of all the key variables; however, multicollinearity may persist with low values of inter-item correlation. The variance inflation factor for all variables is found well below the threshold value of 10, thus rejecting the concern for multicollinearity (O'Brien 2007). After adjusting for heterogeneity and removing outliers using the standard deviation method (3σ), the results of the random effect models are estimated for the value relevance and earnings management models (Table 4). Panel A reports the estimated results of Model 1 of the value relevance equation: the book value per share (coefficient value = 2.48, $p < 0.00$) and EPS (coefficient value = 6.41, $p < 0.01$) are positively and significantly related to the stock price of the firm. Table 4 presents the results of Hypothesis 1—whether ARPT as a proxy for earnings management reduces the level of value relevance. Panel A in Table 4 reports that ARPT is negatively associated with the stock price, a proxy for value relevance (coefficient value = -0.34). The relationship is also statistically significant at $p<0.001$, thus supporting Hypothesis 1. The interaction between EPS and ARPT is found to be statistically significant (coefficient value = -0.12, $p<0.001$). These results are inconsistent with previous studies (Chen et al 2001; Ge et al 2010). The model fit reports R^2 and adjusted R^2 of 0.289 (0.286) for the value relevance equation, and the F-statistics are found statistically significant at an appropriate level ($p<0.00$).

Conclusion

Accounting information is relevant to the stock prices of listed companies in India, and improving the reporting standards of accounting information would raise investor confidence in the authenticity of the reported and published financial statements. earnings management through related party transactions reduces the value relevance of accounting information and good governance mechanisms are likely to restrain earnings management in Indian firms. The study employs a random effects regression model to test the hypotheses, and the results support both hypotheses. These findings have important implications. Good corporate governance practices can limit earnings management in Indian firms. Policymakers and regulators can use these findings as signals to undertake reforms or policy initiatives in governance practices, and they can promulgate improved standards of codes and guidelines on governance practices concerning related party transactions to moderate the earnings management practices of Indian firms.

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