# Corporate Governance and Firms Performance: Review of research in the light of recent reforms in India

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**Abstract**

**Purpose**- Corporate governance has grown as an important mechanism over the last two decades. This paper discusses the new expectations and key challenges for the governance practices to mitigate the conflicts between the shareholders in the wake of corporate governance reforms. A closer insight into the nature of Governance-Performance link for top management in developing economies like India will provide much needed useful information to both regulatory bodies and practitioners for the evaluation of the current reforms and provide a base for future reform measures. This paper seeks to deal with these issues.

**Design/methodology/approach** – A review of available literature was summarised to identify the governance factors affecting the firm's performance so that least studied governance factors will be taken into consideration for future research for governance-performance link.

**Findings** – The majority of the findings from the review showed that the various board attributes are significantly (whether positive or negative) associated with the performance. However, board provenience and the board interlocks variables are least studied variables in the review but these two can make significant contribution to the existing literature if studied more in future research. Moreover, the impact of remuneration of directors on firm's performance is studied, but it is not broadly studied inversely.

**Originality/value** – Considering the other literature and research, this paper provides an insight into the link between various governance factors and performance.

**Paper type**- Literature review

**Keywords:**

Corporate Governance, Financial Performance, Board, India.

## Introduction

The Liberalization, Privatization and Globalization are witnessed in the last decade of the twentieth century. As a result of it, Indian economy is integrated with world's economy in terms of product, capital and labour market. This integration necessitates the parameters like corporate culture, code of conduct and business ethics. Good corporate governance can improve the prospectus for attracting long-term capital. Especially the Privatization and Globalisation affected the corporate governance a lot. Privatization leads to transfer of ownership from the state to new private and public owners like management, employees, local individuals, institutions and foreign investors etc. This new diversified ownership structure creates the traditional Agency problem whereby self-interested executives aim to maximise their private interests rather than the owner's interests.

Along with this a new unique principal-principal agency problem is created in which large or majority shareholders often control the minority shareholders and expropriate the interests of minority shareholders in the firm through both economic and social mechanisms (Dharwadkar et al., 2000). In economic mechanism, dominant shareholders have greater control of firms through interlocking ownership. Using social mechanisms, they appoint their friends and family members to top management positions and these members may then have incentives to disregard minority shareholders interests.

After globalisation foreign investors attracted towards the tremendous opportunities for investment that emerging economies like India provide through its industrial policy reforms. In 2004 India became the second most attractive FDI location among manufacturing investors (Kearney, A. C., 2004). The foreign direct investments in India are more skill intensive rather than capital intensive. Due to global market competition there is a need to attract talent from a worldwide employment pool and this need became the motivation for Indian firms to improve their corporate governance and adopt international corporate governance standards (Khanna & Palepu, 2001).

In response to many corporate scandals such as Enron, Worldcom and Adelphia, many major reforms have been initiated by various stock exchanges and regulatory bodies across different countries. These reforms were initiated to create a system of greater control over managerial actions and to restore investor's confidence in firms.

The recent global financial crisis has reinforced the importance of good corporate governance practices and structures. It is now well recognized that corporate governance structures play an important role in enhancing firm performance and sustainability in long term (Erickson et al., 2005; Ehikioya, 2009; Iwasaki, 2008; Cho and Kim, 2007). There has been considerable research on corporate governance structures and firm performance, particularly, in the developed countries. However, there has been modest research on the influence of corporate governance variables, such as, board structure on firm performance in India (Dwivedi and Jain, 2005). India as an emerging economy, is gradually moving from controlled to market based economy with market capitalization of all listed companies touching nearly rupees 1 trillion (Sehgal and Mulraj, 2008). Corporate governance has now become a norm in India, with Securities Exchange Board of India (SEBI) making it mandatory for all the listed companies to adopt Clause 49 of the Listing Agreement. However, capital markets are still nascent, and market for corporate control is weak (Standard and Poor, 2009). Indian firms are predominantly of the family origin and promoter controlled (Chakrabarti, 2005). Corporate governance, therefore, relies much on internal structures rather than external ones for enhancing the firm value.

The vital need of corporate governance was first realized in India with the Harshad Mehta's securities scam that was uncovered in April 1992 involving a large number of banks and resulting huge changes in the stock market for the first time since the initiation of reforms in 1991.

After Liberalisation, the most significant event in the growth of corporate governance in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992. Since its establishment, in order to review governance challenges and to recommend governance laws and reforms SEBI has constituted several major committees. Recently on 4th Jan, 2013 this Capital Market Regulator has proposed measures to strengthen corporate governance at Indian companies in a move to match best global practice and win investor's confidence. These measures include separating the role of chairman and chief-executive to promote the balance of power. Along with this, SEBI also proposed that independent directors at listed companies must be elected by minority shareholders, ending their appointment and removal by majority shareholders this will lead to solve the principal-principal agency problem. Brown L. D. (2009) used a unique database provided by institutional shareholders services and studied the effect of 51(mandated and non-mandated) governance provisions by the U.S. stock exchanges on operating performance of the firms. It was found that none of the nine governance provisions which were mandated by the U.S. stock exchanges are significantly and positively linked to firm's performance, whereas six of the remaining 42 governance provisions not so mandated are significantly and positively linked to firms operating performance.

**Objectives of the Study and Methodology**

Considering all the above issues in mind, this paper is a venture to bring to light the corporate governance reforms in India and presents a refined integrated framework regarding Governance – performance link which would be of great help to the practitioners and researchers in this field. This would further pave a way to provide direction and find consideration in further empirical studies to test its reliability and applicability in their research work.

The study is based on extensive review of literature so as to trace out the corporate governance factors affecting the firm's performance over the years.

**Corporate Governance reforms in India:**

The corporate governance movement in India began in 1997 with the formation of a voluntary code by the Confederation of Indian Industry (CII). In the next three years, almost 30 large listed companies (having over 25 percent of India's market capitalization) voluntarily adopted the CII code. In 1999, the Securities and Exchange Board of India (SEBI)-India's capital market regulator was established and it set up a committee headed by Kumar Mangalam Birla to amend the international standards of corporate governance for listed companies.

Moreover, through the introduction of **clause 49** of the listing agreement, the CII code soon acquired a mandatory status in early 2000, as all companies of a certain size listed on stock exchange were required to act in accordance with their norms. Clause 49 of the listing agreement contains the guidelines on Corporate Governance for all listed companies and applies to all listed companies (or those are seeking listing) having paid-up capital of more than Rs. 30 million and a net worth of more than Rs. 250 million throughout their history. In its present form, Clause 49, called 'Corporate Governance' contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Report on Corporate Governance, and Compliance, respectively. Firms that do not act in accordance with Clause 49 can be delisted and charged with financial penalties.

From 1 April, 2001, over 140 listed companies accounting for almost 80 percent of market capitalization started following a mandatory code which was in line with some of the best international practices. By April 2003, each and every listed company joined the SEBI code. (Fernando A.C. corporate governance-Principles, Policies and Practices: 2012). In the late 2009, a set of voluntary guidelines for corporate governance has been released the Ministry of Corporate Affairs which address myriad corporate governance matters including the independence of the board of directors, the responsibilities of the board, the audit committee, auditors and mechanisms to encourage and protect whistle blowing.

While many companies in India have their prepared basic governance structures such as reasonable board size, some independent directors and independent auditors, but only a few of them followed the whole range of governance mechanisms. Foremost in this regard Infosys Technologies, the Indian software leading company is the one which discloses the extent of its compliance with ten OECD (Organization of Economic Co-operation and Development) corporate governance codes, has boards with a majority of independent directors, independent audit and compensation committees as well as reconciles its financial statements with eight (including two international) accounting standards (Barton et al., 2004). This could be the reason that ICRA has given 1st corporate governance ranking (CGR) to Infosys Technologies in 2012. The emphasis of ICRA's CGR is on a corporate business practices and quality of disclosure standards that address the requirements of the regulators and are fair and transparent for its financial stakeholders. ICRA's CGR Ratings may help the Rated corporate entity in raising funds; listing on the stock exchange; dealing with third parties like creditors; providing comfort to regulators; improving credibility; improving valuation; and bettering corporate governance practices through benchmarking.

**Developments in the Conceptual Framework**

Corporate governance is the system by which companies are directed and controlled (OECD April, 1999). It involves regulatory and market mechanisms, and the roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. In contemporary business corporations, the main external stakeholder groups are shareholders, debt-holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees. All the research on the corporate governance has mainly dealt with the efficacy of various mechanisms that can protect shareholders from self-interested executives (Daily, Dalton and Cannella, 2003). According to review following are the main corporate governance factors that affects the firm's performance.

**Corporate governance Factors and Performance:**

**1. Board Characteristics**

Introduction of new practices and structures and changes in the composition of boards as a result of reforms and other forces, it is important to test whether these have an impact on firm's performance or not. As the composition of board include various characteristics like percentage of women (Gender), independent directors (Board Autonomy), directors shareholding, foreign directors (Board Provenience) etc., it would be quite useful to examine how greater diversity affects board dynamics and company performance.

**Board independence and Performance:-**

Berthelot, S., et.al (2012) conducted a study on a sample of 355 observations from 199 Canadian listed companies. Partial least square analyses were performed in the study. Results from the study suggested that the percentage of independent directors on the board is significantly and negatively related to the firm's net book value or income.

Gillette, Noe, and Rebello (2003) conducted experiments, using business school students to play the role of directors. It was found that in 30 different mock decisions when the board contained only the inside directors and no one was assigned the role of outside director, the board always chose value destructive projects that benefitted them individually. When outside directors comprised four of the seven directors, they were most effective in promoting value-creation decisions when boards were regularly reshuffled in to random groups rather than intact groups. On the other hand Klein (1998) found no relationship between overall board independence and operating performance but found between insider presence on certain committees (finance and investment) and operating performance.

P.D. Andres (2008) found an inverted u-shaped relation between proportion of outside directors and performance. The result suggested that an optimum combination of executive and non-executive directors is more adequate to create value of the firms than excessively independent boards. Carlos Pombo; Luis H .Gutierrez (2011) found a positive relationship between both the ratio of outside directors and firms return on assets. The results also showed that the outside busy directors turned out to be key drivers of improved firm's performance. Takao Kato & Cheryl Long (2006) also favoured that the appointment of independent directors enhance the turnover-performance link. The study was conducted on 638 Chinese listed firms over the period from 1999 to 2002. Logit regression was used to find out the results.

Chaugh L.C.; Meador and Kumar, A.S. (2010) has investigated that a high proportion of independent directors lowered the performance. Wang y. and Oliver J. (2009) have studied the "Board Composition and Firms Performance Variance: Australian Evidence." The purpose of the study was to investigate the relationship between Board Composition and Firms Performance Variance in the context of recent corporate governance reforms. Board composition measures are denoted by the percentages of affiliated, executive and independent members of the board. Affiliated and independent directors had no significant effect on the level of performance variance. Firms risk was positively influenced by Block holders. Bauer, R. et al (2008) also found that board accountability do not affect stock performance in Japan in their study "The impact of corporate governance on corporate performance: Evidence from Japan."

**Board size and Performance:-**

There has been mixed response regarding linkage between board size and corporate performance. The degree of positive linkage depends on the extent to which board is able to reach consensus, and gain advantage of the knowledge and expertise of the board members. From the extant literature, two divergent views emerged on the linkage between board size and firm value. One the one hand it is argued that larger boards helps in improving the performance of company. A strong positive relationship of board size with the firm value was documented by various researchers (Ehikioya, 2009; Coles et al., 2008; Dwivedi and Jain, 2005; Klein, 2002; Dalton et al., 1999; Kathuria and Dash, 1999; Pearce and Zahra, 1992). There have been more arguments supporting the larger boards. One of the views was that larger boards bring more effectiveness in results by giving directions to specialise (Klein, 2002). Boards with many directors are able to assign more people to supervise and advice on manager's decision. More supervision can either led to reduction in managers discretionary power or at least make it easier to detect managers opportunistic behaviour. Besides, it can increase strategic capabilities to complement that of CEO. The strong evidence to the above was given by Dalton et al., (1999); Pearce and Zahra, (1992). They found that large board's size has increased pool of experts and knowledge and opinion of these experts can be utilized for making some strategic decisions of the board, which can enhance performance of the company. The same has been supported by Goodstein et al., (1994) who showed that the larger board size results in greater monitoring capacity, and also improves the firm's ability to have greater external linkages. Coles et al., (2008) found that firms requiring more advice obtain greater value from the larger boards. But large size of board can face the problems of co-ordination, communication and decision-making. Large boards give excessive control to the CEO, harm efficiency (Yermack, 1996; Eisenberg et al., 1998; Fernandez et al., 1997). In addition this problem is crucial especially in manufacturing industry where fast decision making is needed because manufacturing take more time and heavily reliant on the changing taste and preferences of the customers.

Chaugh L.C.; Meador and Kumar, A.S. (2010) has investigated the relationship between the financial performance and corporate governance for Indian firms. Alternative hypotheses regarding board structure and financial performance were found. It was also found that large board size enhanced the financial performance by creating better opportunities and more resources. Lu, W. et al (2012) studied the effects of corporate governance on airline performance and explored the relationship between operating performance and corporate governance in 30 airline companies operating in US. The efficiency of the airlines was evaluated from the application of Two-stage Data Envelopment Analysis. The results of truncated regression showed that board size has the significant positive relations to performance.

Andres P. D. (2008) studied a sample of 69 large commercial banks from 6 developed countries for the period 1995-2005. He found an inverted u-shaped relation between bank performance and board size. Bank performance decreased as the number of directors increases to a point where the relation hits a minimum from which performance started improving. These results were supported by Ujunwa A. (2012) in his study entitled "Board characteristics and the financial performance of Nigerian quoted firms". He investigated 122 quoted firms in Nigeria between 1991 and 2008 using panel data and found that Board size was negatively linked with firm performance. The empirical findings of Kumar N. And Singh J.P. (2013)

**Board meetings and Performance:-**

The analysis of relation between board composition and performance is incomplete if we don't consider the internal functioning of the board. Vafeas (1999) noted that there are several other factors that can affect how boards operate. One of them is the frequency of board meetings. From meetings Board members gets a chance to come together and discuss and exchange the ideas on monitoring strategies. More frequent the meetings, closer the supervision and control over managers, the more relevant would be the advisory role. All these will lead to a positive impact on the performance (proactive boards). On the other hand, frequent meetings might also be a result of board's reaction to poor performance (reactive boards).

P.D. Andres (2008) found a positive relationship between the number of board meetings and bank performance. The results supported that bank board meeting play a role that is more proactive than reactive.

But on the other hand, Berthelot, S., et.al (2012) found that the frequencies of board meetings are negatively related to the firm's net book value or income.

**Board interlocks and Performance:-**

An interlock directorship is present when a person serves on the board of more than one corporation and thereby generates a link or interlock between the companies. Carlos Pombo; Luis H .Gutierrez (2011) found the positive relation between the degree of board interlock and return on assets. Their study was conducted on a sample of an average of 335 firms per year for the 1996-2006 periods. Fich & White (2005) estimated two measures of interlocks: the average number of seat held by the chairman of the board and the average number of seat held by the other directors. They tested how these two measures related with Tobin's Q. The results showed that the number of seats held by the chairman of the board in listed companies affected the good governance. It was also showed that when both the chairman and other directors hold seats on board of non-listed companies, the firms performance was impaired because of busy board don't perform their monitoring task.

**Board provenience and Performance:**

Board provenience means the percentage of foreign directors in the board. Mersland, R. and Stom, R. O. (2009) examined the relationship between the firm performance and corporate governance in microfinance institutions. They found that financial performance improves with local rather than international directors. Their reports were based on the database covering 278 MFIs from 60 countries gathered from 2000 to 2007. The reported results were from random effects panel data estimations of the relationship between financial performance and three dimensions of governance.

## 2. CEO Characteristics

- **CEO Duality and Performance**

Takao Kato & Cheryl Long (2006) studied that listed firms with CEO holding additional positions among the controlling shareholder have a weaker turnover- performance link. Lerong He (2008), Anderson & Reeb (2003), McCoughy et al. (1998, 2001) studied that Founder-managed firms are associated with higher financial performance and more likely to survive than professionally managed firms. This association got stronger when the position of CEO and chairperson of the board is combined. Founder-managers have strong economic link with the firm. Founder-managers are managers who tend to own a large fraction of their firm's equity and are the longest tenured members in their organisations.

Augustine Ujunwa (2012) investigated 122 quoted firms in Nigeria between 1991 and 2008 using panel data. He found that CEO duality was negatively linked with firm performance. Aik Leng A. C. and Mansor S. A. (2005) conducted a study on "Can good corporate governance practices contribute to firms' financial performance? – Evidence from Malaysian companies" based on data involving 120 Malaysian-listed companies over a four-year period from 1996 to 1999. The study used Return on Equity (ROE) as the dependent variable. CEO Duality exerts a positive influence on company earnings. The study suggested that dominant CEOs could increase performance of firms by dominating the decision-making process in their companies.

Takao Kato & Cheryl Long (2006) found that there is no significance impact of CEO duality on turnover performance sensitivities. Chaugh L.C.; Meador and Kumar, A.S. (2010) has studied that CEO-Duality had not contributed much to the financial performance. Furthermore, Lu, W. et al (2012) studied the effects of corporate governance on airline performance and they also found that CEO-Duality present significant negative relations with performance.

- **CEO compensation and Performance**

Nulla, Mohammed Y (2013) investigated the effect of CEO age on CEO compensation using accounting performance as an independent variable from 2005 to 2010. They observed that there was a relationship between CEO salary, CEO bonus, CEO total compensation, CEO age, and accounting performance among all CEO age groups. The quantitative research and stratified sample methods were used for the study. Lerong He (2008) studied that there are two types of CEO-compensation. These are incentive compensation and total compensation (overall pay level). Incentive compensation is the variable part of CEO annual compensation which includes the sum total of bonus, long-term incentives awards, restricted stock awards and the stock option grants. While total fixed compensation includes base salary, annual bonus, and incentive compensation. The researcher applied the ordinary least square (OLS) regression with stratification method to estimate the compensation regression. The paper revealed that Founder CEO are associated with smaller incentive and total compensation compared with professionals CEOs because of their larger job security and unique intrinsic characteristics distinct from professionals CEOs.

Mengistae and Xu (2004) used survey data in the 1980s and investigated CEO pay in approximately 400 Chinese SOEs. They found that the CEO pay sensitivity decreases with the variance of performance. Kato and Long (2006) examined a sample of 937 firms listed in China between 1998 and 2002. They found positive link between the executive cash pay and firm performance. Firth et al. (2007) examined a sample of 549 listed firms in China between 1998 and 2000. They found ownership and governance factors as determinants of cash pay and a link between cash compensation and firm performance. In the earlier related research, Firth et al. (1999) examined cash compensation in Hong Kong and found that there is a little statistical correlation between pay and firm's stock market performance.

Bauer, R. et al (2008) investigated the relationship corporate governance and corporate performance in Japan. A unique governance index was used to rate the firm's corporate governance using six different categories. The relationship of each sub-index with stock price performance was investigated. It was revealed that remuneration has a significant impact on stock performance. Lee, K. W. et al. (2008) examines the association between the dispersion of top-management compensation and firm's performance. The results showed that firm's performance measures like Tobin's Q or firm's stock return, is positively associated with the pay dispersion of top management.

- **CEO turnover and Performance**

Takao Kato & Cheryl Long (2006) studied unique data on Chinese listed firms from 1998 to 2002 and found that CEO turnover is significantly and inversely related to firm performance. The study also revealed that the turnover-performance link is weaker for listed firms that are still controlled by the state. He researchers used the logit model to estimate turnover-performance sensitivities. The results of this study were also reassured by Xu et al(2005) which provided evidence that executive turnover is an effective mechanism in reversing a company's performance in China.

## Conclusion

In the era of recent corporate scandals and legislations, the monitoring function of the board is clearly a vital one to perform, but monitoring is not enough. Johnson, Daily, and Ellstrand (1996) and Daily, Dalton and Cannela (2003) strongly agreed that the boards can also enhance the performance of the companies by providing strategic advice, securing external resources, developing managerial capabilities, and helping to manage the firm during a crisis. Hillman and Daiziel (2003) proposed a model to integrate the agency and resource dependence prospective. They argued that greater levels of " Board Capital"(a combination of Director's Social capital and Human capital) should not only leads to secure more resources and provide superior advice but also enables boards to have more effective monitoring of company performance.

The governance reforms of India have emphasized the importance of independent directors and define the minimum number and the responsibilities of these directors. But in India there is a shortage of qualified independent directors. However, this problem could be resolved by the training programs but they can only provide general guidance. So another solution could be the appointment of more foreign directors which is likely to be there due to opening up of India's capital market to foreign investors.

It was further observed in the review of literature that Board Interlocks and Board Provenience are least studied corporate governance variables in relation to the firm's performance. So there is a need to have more research on these variables for the better assessment of total impact of board attributes on firm's performance. Moreover, the impact of remuneration of directors on firm's performance is studied, but it is not broadly studied inversely.

In particular, to have more efficient board, there is a need for more longitudinal research studies that can trace out the evolvement of boards as firms passes through different stages of development and which board characteristics are more effective at each stage. Such research would also be helpful in determining the effect of changes in board practices on the performance of the firms in contrast to the majority of the research that has focused on Cross-sectional comparisons.

Now days, ratings of corporate governance are gaining importance for two reasons: first, institutional investors that are playing an increasingly major role in the capital markets use ratings; secondly the low rating scale could be an incentive for company management to pay closer attention to the problem of corporate governance (Khanchel I., 2007). But data sources on which rating are done is quite important. The corporate should make use of new data sources which are used for rating the firms on the quality of Board governance by various consultancy firms (Johnson and Greening, 1999). But Brown, 2003 argued that these rating systems used to combine the diverse proxy and other more subjective measure of good governance practice that appears to be linked with firm stock and social performance. The growing influence of these ratings carries the risk of difficult assessment of what board practices truly reflects better governance. The reason behind this risk is the detailed guidance provided by the rating firms to their clients about what changes they need to make to their board in order to have a top governance score. This could lead to the adoption of a number of symbolic changes in practice or composition that boost their rating rather than making a genuine effort to have improvement in board effectiveness.

In addition, given the regulations to prevent future corporate scandals, it would be useful to have more exploratory research on which board attributes can promote more ethical corporate behaviour and make boards more effective in managing a crisis (Harrison and freeman, 1999). Furthermore, the environment in which companies are operating has changed dramatically in India since 1991, there is a need to switch over from the most used financial indicators i.e. Return on Investment(ROI) and Return on Assets (ROA) to other dimensions of performance such as firms ethical behaviour as measured by the extent to which firms are guilty of fraud, the likelihood of a firm being sued by the shareholders because the performance variables like accounting returns are the indirect measures of the extent that a board's effort protect shareholder interest. The greatest results could come from the combination of different measures-financial, ethical/legal and social performance to see what type of boards perform better on some measures than others because the company that perform poorly on either financial or legal criteria are more likely to become targets for shareholder activism to change board membership, board composition and practices. If only accounting performance variables are used then researcher should employ the methodology with more explanatory power so that causality and maintenance of effective corporate boards can be measured more efficiently. Moreover, there is not enough theoretical framework is provided on effect of mandated and non mandated governance provisions on the firms performance to ensure the relevance of mandatory and voluntarily corporate governance guidelines.

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