Corporate Governance Index and firm performance

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ABSTRACT

The paper studies the impact of compliance with non-mandatory disclosures in corporate governance on the performance of Indian firms in the context of guidelines given by the market regulator, Securities and Exchange Board of India (SEBI).A sample is drawn from BSE100, an index of large firms listed on the Bombay Stock Exchange. The authors develop a self-constructed Corporate Governance Index (CGI), which represents the disclosure score. Ordinary Least Squares regression is then used to test whether CGI has a significant impact on two measures of firm performance – 1) Price-to-book value, a market based measure and 2) Return on Capital Employed (ROCE), an accounting based measure. The paper finds evidence of a weak, yet significant relationship between the corporate governance index and the market value of firms. However, the index has no impact on the accounting performance of firms**.**

Introduction

We study the influence of voluntary disclosures incorporate governance on performance of Indian firms using market-based and accounting-based performance measures.We use a self-constructed disclosure indexon the basis of information obtained from the corporate governance section within the annual reports of firms. The topic has gained currency in India especially after liberalization in the early 1990s and with the appointment of the market regulator SEBI in 1997.

In the process, we are able to identify some disclosure practices that represent good corporate governance. Moreover, these practices are valued by the capital markets. Weshed more light on studies of corporate governance codes in developing as well as emerging economies. Country specific examples are discussed. After a brief overview of theoretical foundations, we proceed to identify the context of corporate governance in India. This is followed by a description of the regulatory practices which in turn lead to adoption of a suitable sample and methodology for the study. Simple statistical methods are used to analyze the data and present findings.Concluding discussions and Implications subsequently make up the final section.

Literature Review

Significance of Corporate Governance

Corporate Governance is a set of mechanisms

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and processes that prescribes, monitors and legitimizes the right use of shareholder funds (Shleifer and Vishny, 1997). Corporate malpractices in the previous decade, chief among them- Enron, Tyco, Worldcom and Satyam (India) have brought the issue to prominence. Researchers have studied the implications of governance mechanisms in terms of both hygiene and performance implications. Viewed from the management perspective, it directly impacts the top management team which sets out the directions for decision making (Hambrick and Mason, 1984).

Corporate Governance (CG) is also held accountable for providing transparency to capital markets, regulators, governments, institutional bodies and shareholders (Lowenstein, 1996; Aglietta, 2000). Firms making disclosures to their shareholders do so in an attempt to provide transparency: information leads torobust decision making. Disclosures made by firms could be broadly classified into two: Mandatory and Non-mandatory (or voluntary). Mandatory information, which is usually in line with the regulatory body's requirementis related to providing financial information such as the balance sheet, profit and loss statements, description of investments, management policies and earnings guidance. However, going beyond, voluntary or discretionary disclosures which are provided by firms,tend to be qualitative in nature. Firms may furnish voluntary information with a view to reduce information asymmetry and therein expect better value in the capital markets.

Introduction to Voluntary Disclosures

Why are voluntary disclosures significant? Today, scholars and practitioners opine that corporate value is not adequately captured or portrayed through traditional financial tabulations such as the balance sheet, profit and loss statements, etc (Arvidsson, 2011). One reason is that intangible assets and competencies may not be captured adequately. A second reason is that numbers do not reveal sufficient details about the firm's future strategies or whether an adopted strategy proved to be successful in an economic sense. A third reason: firms may have gone beyond the profit motive and spent money, time and effort on activities relating to corporate social responsibility, sustainability and eco-friendly methods of production or waste removal mechanisms. A run-of-the-mill annual report fails to capture many of these additional value-add activities.

The underlying motive behind voluntary disclosures is simple: reduction in information asymmetry. Akerlof (1970) characterized information asymmetry problems in his metaphor of "lemons" in the second hand car sales industry.This is primarily due to the differing interests of owners and managers of the firm. In the capital markets, this is often responsible for an impairment of efficient allocation of resources. While there is an obvious information asymmetry between the insiders (the management team) and the outsiders, who are represented by the shareholders or owners, this can be attributed to the agency problem (Jensen and Meckling, 1976). To mitigate this problem, firms can resort to providing more information by way of voluntary disclosures thereby exceeding the mandatory disclosure regulations (Tasker, 1998).

Theoretical Foundations

We confine our description of theories to those directly impacting voluntary disclosures. Researchers in the field have predominantly identified the following three theories as possessing significance in understanding voluntary disclosures.

Agency Theory

The historical roots of this theory travel very far. Berle and Means (1932) were the foremost to discuss the conflict of interest between the owners of the firm and the managers in the case of large public corporations. Whilst the owners seek adequate return on their capital, managers are self-centered and are keen on ensuring their position and status in the firm. To this end, managers are seen as selfish 'agents' who are promoting their own interests ahead of the firm's objectives. Jensen and Meckling (1976) argued distinctly about the separation of ownership and control; its implications for corporations and the need for monitoring mechanisms to mitigate the agency conflicts.

In the purview of voluntary disclosures, the board and other CG mechanisms seek to minimize information asymmetry through several public release of information that goes over and beyond the mandated set of statements.

Stakeholder Theory

Under the traditional perspective, an organization needs to be oriented towards profit maximization for its shareholders. The stakeholder theory goes beyond the expectations and rights of shareholders. The theory views the corporation as an entity through which a diverse set of participants interact, contribute or support during the course of the corporation's activities (Donaldson and Preston, 1995). It expands to include a larger universe of stakeholders who are different members of society interacting with the organization (An, Davey and Eggleton, 2011). For any firm, the shareholders, suppliers and customers, employees and the society form the stakeholders. From the stakeholder theory, an organization needs to meet multiple goals to satisfy a wider universe of members. In this context, issues such as Corporate Social Responsibility and Sustainable Development become peripheral, yet important objectives for public firms.

The ethical branch suggests that all stakeholders have certain rights that should be protected by the organization. The positive branch seeks to explain and forecast how the organization deals with varying demands of its stakeholders. The organization needs to orient its diverse activities in a manner that is aligned to the interests of powerful parties who could be significant for the long term viability and growth. Common among these parties could be media, political lobbies, activist organizations and regulatory or judicial institutions.

Signaling Theory

Spence (1973) proposed signaling theory to explain information asymmetry in the job markets. In marketing discipline, there are several ways of signaling to customers. Among them, warranties, prices, promotions and visual displays at the point of sale could be some of the more popular ones. Signaling theory has also been useful in explaining the need for voluntary disclosures in the context of Corporate Governance (Ross, 1977). Voluntary disclosures are a means of signaling to shareholders and stakeholders. Organizations may choose to disclose information or choose not to; however, in the absence of perceived competitor threats, most organizations would choose to disclose as much information as possible. Thus voluntary disclosures are seen as a way of signaling to the audience (Shareholders and stakeholders) that the firm is at par with, or superior to others in the industry.

Research in Voluntary Disclosures: the use of CG ratings

If voluntary disclosures are important, do they have a significant bearing on the performance of firms? This question caused several scholars to

study voluntary disclosures and its relationship with firm performance. The performance outcomes could be both market based and accounting based measures.

How can one compare firms on CG? This can be done by developing CG ratings or indices. Deminor, based in Brussels is an independent consulting practice that handles a wide variety of financial advisory services for firms in Europe.[1] The company also provides corporate governance ratings for both firms and investors. Deminor states that the ratings are based on its independent valuation and it involves a blend of quantitative parameters and qualitative factors as well. Qualitative factors have been arrived at using the one-on-one interviews with senior management members.The Governance Metrics International (GMI) rating system uses more than 600 data points that study seven broad categories of analysis: board accountability, financial disclosure, shareholder rights, compensation policies, market for control, shareholder base and corporate reputation. The CGQ rating is produced by Institutional Shareholder Services (ISS), a division of RiskMetrics[2].

There have been studies by researchers to assess the impact of these ratings on firm performance. The results have been of a mixed nature. For instance, Renders, Gaeremynck and Sercu (2010) used the Deminor ratings to find evidence of a positive relationship between corporate governance ratings and performance, provided that endogeneity and selection bias are controlled. Gompers, Ishii and Metrick (2003) find a positive relationship with stock returns; Larcker, Richardson and Tuna (2007) finds some association with operating performance and stock returns, Bhagat and Bolton (2008) find a positive relation with the operating performance of firms. To contrast, we also have some research that finds negative relationship with firm performance (Bauer, Gunster and Otten 2004) in a study of 250 firms from FTSEurofirst300 and an instance where there is limited evidence of a relationship with performance and firm value (Daines, Gow and Larcker 2008).

Corporate Governance Ratings: India

In India, two research organizations have published ratings for a small set of companies. Credit Rating and Investment Services of India Ltd (CRISIL) has developed a mechanism called Governance and Value Creation (GVC) ratings for firms based on their corporate governance practices.[3]As of now, only 8 firms have voluntarily engaged CRISIL for their rating services. The scale ranges from CRISIL GVC Level-1 to Level-8, where 1 is the highest level of corporate governance and value creation and 8 is the lowest.

A similar rating service is also provided by Investment Information and Credit Rating Agency (ICRA).It has developed ratings[4]where 8 firms have voluntarily given information for the purpose of rating. A third company, Credit Analysis and Research Limited (CARE)[5]has also undertaken Corporate Governance Ratings (CGR) and there are 6 levels with 1 being the highest level of CGR and 6 being the least.

Corporate Governance Index: Indian Firms

A Corporate Governance Index (hereafter referred to as CGI) can be taken from reputable sources such as those maintained by Deminor for European countries or Governance Metrics International (GMI) who maintain a comprehensive list of ratings for American companies. In the Indian context, the rating agencies, CRISIL, ICRA and CARE have few companies thatsubscribed

to the CG rating services. Hence the ratings cannot be used for the purpose of research. In such a scenario, there are two methods that can be employed: 1) Obtain the corporate governance ratings from companies through a questionnaire format or 2) Use self-constructed Corporate Governance Index using publicly available sources. For the purpose of this study, a self-constructed CGIhas been developed using voluntary disclosures as given in the CG section of the annual reports of firms.

In India, the market regulator, Securities and Exchange Board of India (SEBI) has developed the clause 49 under the purview of the listing agreement for the purpose of developing sound corporate governance compliance mechanisms.[6]This has two parts. The first part is mandatory and needs to be submitted every quarter along with the company's financial reports.The second part has a list of non-mandatory requirements which are purely voluntary. Companies may use their discretion to disclose their compliance to these requirements.

For the purpose of this study, only the voluntary disclosures have been considered. In the self-constructed CGI, each statement from the non-voluntary disclosures is perused;additionallythe corporate governance report is also referred. This is filed along with the company annual report. A complete list of non-mandatory disclosures, based on clause 49 of SEBI is given in Appendix I. For our research, we answer each question as a "YES" if the voluntary guideline has been complied with or "NO" in the case of non-compliance. A total of 11 questions have been answered with binary responses. This method has parallels from previous research literature (Garay and Gonzalez, 2008; Klapper and Love, 2004; Leal and Carvalhal-da-Silva, 2005) in the construction of the CGI. In our case, the non-mandatory disclosures have a maximum score of 11. A brief overview of prior research: 4 broad-category constructs with 15 items (Leal and Carvalhal-da-Silva, 2005) and a 17 item CGI construct (Garay and Gonzalez, 2008) in the case of a Venezuelan survey. Hence, the context of the country and the specific regulator's code (SEBI in the case of India) assumes more significance for research.

Hypothesis Development

As discussed in the literature review, CGI is expected to be positively related to firm valuation. Prior research has supported a positive relationship between corporate governance ratings and firm value (Black, 2001; Black, et al., 2006; Durnev and Kim, 2005; Garay and Gonzalez, 2008; Khanchel El Mehdi, 2007; Klapper and Love, 2004). Extending the results from the study further, it can be stated that a larger number of disclosures are more likely to help investors look at the firms with a favorable viewpoint. Therefore, such firms are more likely to generate interest from both retail and institutional investors. Consequently, the first hypothesis is observed as

Hypothesis 1*: A higher level of compliance to non-mandatory disclosures would be positively related to the firm valuation*.

The second area of interest lies in understanding the relationship between CGI and the accounting measures of the firm. Prior research in this domain has surprisingly found lack of support for the relationship of corporate governance ratings with firm performance (Black et al., 2006; Klapper and Love, 2004). These measures could be Return on Capital Employed (ROCE), Return on Investment (ROI) or other related measures. Good governance can be assumed to be an outcome

of boards that can translate their knowledge and skills (Input) through an effective utilization of these skills (process), so that the output is manifested in the form of enhanced performance of the firms. However, there is a stark difference between the presence of knowledge and skills and how this tacit knowledge (Nonaka, 1994) can be converted into functional utility that can benefit the firm's performance (Forbes and Milliken, 1999). A greater emphasis on board level processes may not necessarily result in increase in the firm's accounting profits. It is therefore reasonable to structure our second hypothesis in the null form:

Hypothesis 2: A higher level of compliance to non-mandatory disclosures is not related to the firm's performance as measured through Return on Capital Employed (ROCE)

Methodology

Dependent Variables

The dependent variables are chosen to be 1) Price-to- book value (PR_BOOKVAL), which is a market based measure, also finding precedence from a study of 46 Venezuelan firms (Garay and Gonzalez, 2008) and 2)An accounting based measure, Return on Capital Employed, (ROCE) which is a firm's internal measure of performance. The first measure is a reflection of the market perception or sentiment of the firm based on past performance and future earnings potential, while the second is an indicator of the firm's internal efficiency of operations.

Independent Variable

This paper considers the CGI to be represented by the non-mandatory score from voluntary disclosures, DSCORE which is the independent variable. To compute DSCORE for each firm, the number of "YES" responses is counted. This is divided by 11 to obtain the firm's DSCORE. If a firm scores 5 "YES" responses, then its DSCORE is 0.45.

Control Variables

Control variables are used in this study as follows: 1) LN_SALES, which is the natural logarithm of sales has been used to control for firm size, 2) PROFIT: Profitability as measured through the ratio of Profit After Tax to Total Sales (PAT/Total Sales) and 3) IND_DUMMY: Industry effects captured through an industry dummy that takes the value 1 for a manufacturing firm and 0 for a services firm.

Sample Selection

This paper selects the 100 firms from the BSE 100 index;this index represents large, listed companies on the Bombay Stock Exchange.Their turnover is in the region of Rs. 10 billion and above. Thedatabase, PROWESS managed by the Centre for Monitoring of the Indian Economy (CMIE) was used to obtain comprehensive firm specific information for all the listed firms.

Observations pertain to the financial year 2012 (As on 31st March, 2012). The 90-day average of share prices during the period 01 January 2012 to 31st March 2012 has been used for computation of the Price-to-book value. Sales are for the fiscal year: April 2011 to March 2012. Assets, leverage, age, Return on Capital Employed (ROCE), details pertain to the fiscal year 2012.

Exclusions

After analyzing the firms' preliminary financial details, some exceptions are noticed and therefore such firms are removed from the

sample. The criteria for exclusion of certain firms are taken as follows: 1) firms that have abnormal values for price-to-book value, 2) missing data for some variables and 3) firms which are public sector undertakings operating in a price-regulated environment. This leaves us with 88 firms, forming our sample.

Analysis and Results

CGI comparative results: emerging markets

On non-mandatory score, the mean score for 88 Indian firmsis 48%, which compares favorably with studies from other countries. Refer Table 1 for a comparative study.

Table 1: Comparative Results for CGI (In %)

	This Paper	Garay & Gonzalez, (2008)	Klapper & Love (2004)	Leal & Carvalhal-da Silva (2005)
Country	India	Venezuela	25 Emerging Markets	Brazil
Observations	88	46	374	214
Mean	48	40.34	54.11	41.67
Median	55	40.47	54.97	41.67
Standard Deviation	23.21	12.11	14	8.33
Maximum	91.90	71.67	92.77	79.17
Minimum	0	16.67	11.77	16.67

The descriptive statistics for our sample are given in Table 2. We observe that the DSCORE has a mean of 0.48 and a standard deviation of 0.23. Average profitability is 15%.

Table 2 : Descriptive Statistics

Variable	Mean	Std. Deviation
PR_BOOKVAL	3.50	2.79
ROCE	14.24	12.94
PROFIT	0.15	0.29
LN_SALES	11.32	1.13
DSCORE	0.48	0.23

Multivariate Analysis

The multivariate analysis is performed in two parts: 1) regress a market-based measure Price to Book Value (PR_BOOKVAL) against voluntary disclosure score (DSCORE). The control variables are PROFIT, LN_SALES and IND_DUMMY 2) Regress an accounting measure, Return on Capital Employed (ROCE) against DSCORE, where the control variables are LN_SALES and IND_DUMMY. The regression output is shown in the subsequent tables.

Regression of price to book value (PR_BOOKVAL)

The Pearson correlations (Table 3) show that the

independent variables are not correlated to each other. The values are well below 0.4, which is the trigger point The Variance Inflation Factor (VIF) is 1.1 for each of the six variables. It implies that there is very negligible multi-collinearity in our variables. The Durbin Watson test statistic is 2.26 indicating the absence of autocorrelation.

Table 3 : Correlations

	(a)	(b)	(c)	(d)
(a) PR_BOOKVAL	1.00	-	-	-
(b) DSCORE	0.03	1.00	-	-
(c) LN_SALES	-0.03	-0.02	1.00	-
(d) PROFIT	0.05	-0.12	0.25	1.00

Table 4 : Regression: Price To Book Value

	Coefficients	t	Sig
(Constant)		0.66	
DSCORE	2.25	1.75	***
LN_SALES	-0.10	-0.40	
IND_DUMMY	2.43	3.99	*
PROFIT	1.41	1.41	

* $p < 0.01$

** $p < 0.05$

*** $p < 0.10$

R^2=0.17,

Adjusted R^2=0.13

F = 4.12, significant at p<0.01

We refer Table 4 for the regression results. It is evident that except for size and profitability, all the other independent variables are significant:voluntary disclosure is significant at 90% level.The coefficient has the sign in the right direction. The strongly positive coefficient indicates that markets value voluntary disclosures. We also note that the standardized coefficients are significant and positive. It can be inferred that the market perceives these disclosures to signify higher valuation of the firms. This has parallels with literature on corporate governance ratings in emerging markets, where the ratings have a significant positive impact on market value (Black, 2001; Black, et al., 2006; Durnev and Kim, 2005; Garay and Gonzalez, 2008). Additionally, these disclosures are aimed at greater transparency and better hygiene factors for governance even though they may not be completely relevant for the firms' routine operations. Therefore, the hypothesis 1 is supported.

Regression of Return On Capital Employed (ROCE)

Here, the control variables arethe industry dummy (IND_DUMMY) and natural logarithm of sales (LN_SALES). For this regression, the R^2 is 0.20, indicating that about 20% of the variance in the dependent variable is explained by the predictor variables. Table 5 gives details of the regression coefficients and their significance.

Table 5: Regression: Return On Capital Employed (ROCE)

Variable	Coefficients	t	Sig
(Constant)		-0.55	
DSCORE	4.72	0.83	
LN_SALES	2.68	2.40	**
IND_DUMMY	10.82	4.03	*

** $p < 0.05$

* $p < 0.01$

R^2 = 0.202,

Adjusted R^2 = 0.173,

F = 7.07, significant at p<0.01

From Table 5, it can be inferred that except for DSCORE, all the other variables are significant. The coefficient of LN_SALES has a positive sign suggesting a direct relationship between the firm size (as proxied by Sales)and the ROCE. It is evident that the CGI represented by DSCORE has no significant relationship to ROCE.Hence, our hypothesis 2is supported. A quick review of prior research in emerging markets (Black, et al., 2006; Klapper and Love, 2004) supports our findings from the Indian context and they are also in line with research findings from the European context (Bauer, Gunsten and Otten, 2004).

Conclusions

The conclusions of this study are in line with similar research in emerging markets (Black, 2001; Black, et al.; Durnev and Kim, 2005; Garay and Gonzalez, 2008);it is found that the CGI or non-mandatory scoreis significantly related to firm value. Firm value has been measured by the ratio of Price to book value (PR_BOOKVAL) in this study. For the Corporate Governance Index, (CGI), represented by DSCORE, the coefficient is positive and significant indicating a positive relationship with firm value (PR_BOOKVAL).

With regard to the accounting measure, the study finds no significant relationship of the CGI,DSCORE with ROCE. Again, this supports findings from earlier research in this domain (Black, et al., 2006; Klapper and Love, 2004) which broadly discuss the absence of any relationship of CGI with the firm's accounting performance.

For firms, the study implies that more disclosures are likely to result in higher valuations by investors. Accordingly, it is in the interest of firms to not only ensure disclosures in line with the provisions of clause 49 put forth by SEBI, but ensure that internally, they undertake measures that reflect their commitment to compliance so that on-the-ground best governance practices are observed. For regulators, the study is heartening in the sense that firms are willing to be more transparent about hitherto confidential information, leading to enhanced governance mechanisms.

Limitations, Implications for Future Research

The relationship of CGI has been studied using a sample of 88 firms based on the BSE100 index. This predominantly contains only the largest firms in the country. Most large business groups are part of the sample. Besides, the sample contains two or three firms within each business group such as Tata, Birla or Reliance. Hence the results are also likely to reflect the corporate governance practices prevalent in larger companies. It is quite likely that larger companies are more eager to protect their corporate brand identity and therefore engage in more disclosures on the governance front. An ideal sample should contain firms of all sizes drawn from different sectors. A second limitation is that some sectors are represented by just one firm. Illustrative cases are from sectors such as Agriculture, media and publishing, textile and tourism, where there is just one firm (from each of the four sectors) in the BSE100 index. A broad-based index would be an ideal platform for this type of research. A third limitation has to do with the computation of the CGI. We have used a non-weighted method for our computation. This is chiefly because the mandatory disclosures are being made by most firms and significant variance is observed only in the non-mandatory section. In addition, there is lesser number of non-mandatory disclosures (11) compared to the mandatory disclosures (20). Yet, certain studies have used weighted measures (Garay and Gonzalez, 2008) for each factor within the corporate governance framework.

Since rating agencies in Indiado not have firms' corporate governance ratings, it is suggested that the findings from this research would serve as an impetus for rating agencies to encourage reputed firmsto disclose information for independent rating mechanisms; availability of these ratings to the investors would possibly facilitate lower cost of capital. Besides, the reputation of these firms is likely to be enhanced. Compare the Indian scenario to that of European rating firms: rating agencies such as Deminor and Governance Metrics International have enhanced corporate governance credibility. For the regulator, SEBI, the findings from this paper could suggest more stringent watch-dog procedures for compliance. This would stress on firms adherence to best practices in governance.

Further studies in this discipline could take a larger base of firms across all market capitalizations. They could also look at incorporating characteristics of the board; it would ideally represent governance mechanisms. Studies which incorporate governance mechanisms which represent the process aspect in addition to the governance ratings (the compliance aspect) are expected to enhance the explanatory power of corporate governance in understanding firm valuation and performance.

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APPENDIX I

Format of Quarterly Compliance report

NON-MANDATORY DISCLOSURES

The Board

1. Non-executive chairman maintaining a chairman's office at the company expense
2. Independent directors' tenure not to exceed 9 years

Remuneration Committee

3. Company's policy on remuneration packages, pension rights and any other compensation payment
4. At least 3 non-executive directors to be on this committee; the committee should be headed by an independent director
5. All members of the remuneration committee should be present at the meeting
6. Chairman of the remuneration committee should be present at the AGM, however he can decide who will answer shareholder queries

Shareholder Rights

7. Half yearly declaration of financial results, significant results should be sent to each shareholder

Audit qualifications

8. Company should move towards a regime of unqualified financial statements

Training of Board Members

9. Board members to be trained in the business model of the company as well as the risk profile of the business parameters.

Mechanism for evaluating non-executive Board Members

10. A group & a mechanism needs to be defined for evaluating non-executive board members

Whistle Blower Policy

11. A mechanism for employees to report any concerns of fraud, unethical behavior or violation of code of conduct of the company

[1] Retrieved from Deminor Web site: http://www.deminor.com/(2012, Oct31)

[2] Retrieved from ISS Website: http://www.issgovernance.com/(2012, Oct 31)

[3] Website showing CRISIL ratings for Indian firms http://www.crisil.com/ratings/gvc-ratings-list.jsp (2012, Oct 31)

[4] Website showing ICRA ratings for Indian firms http://www.icra.in/CurrentRating.aspx (2012, Oct 31)

[5] Website of CARE: http://www.careratings.com/scripts/Home.aspx (2012, Oct 31)

[6] Refer to clause 49 of SEBI's code on corporate governance: http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf(2012, Oct 31)