

RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FIRM'S PERFORMANCE

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ABSTRACT

Recent corporate frauds associated to accounting and other scandals purportedly blamed to top company's managers have brought into public eyes the recurring question of whether companies are managed on the best interests of stakeholders. A survey was conducted in 2002 by McKinsey & Company which found that about 80 percent of institutional investors pay a premium for a well-governed company. The company's monitoring function is substantial part of corporate governance of which effectiveness can be determined by its independence, size and composition of board of directors. Present study makes an attempt to know the impact of board size (Number of Directors) and its independence on firm's performance.

Key Words: Corporate Governance, Size of Board of Directors, Independence of Directors, Performance.

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Introduction

Corporate governance has been a vital issue in developing countries because of the reality that corporate governance and economic development are inherently associated. In India, the question of Corporate Governance has come up mainly in the wake of economic liberalization and de-regularization of industry and business. The demand for corporate ethics and stricter compliance with the laws of the land has also contributed to the need for Corporate Governance. Corporate governance is a very wide concept that contains entire mechanisms by which stakeholders of a corporation maintain control over corporate insiders and management so that their interests can be protected. Parties concerned in corporate governance include the regulatory body (e.g. the board of directors, the Chief Executive Officer, management, shareholders and Auditors) and other stakeholders who take part include suppliers, employees, creditors, customers and the community at large. Generally major part of corporate governance reflects in control of board of directors over management. Monitoring role of directors is an important component of corporate governance. The effect of such departures in current practice on firm performance and proposals for reforms of the corporate board has attracted recent attention from academics and practitioners. So it has always been a controversial and debatable issue whether corporate governance affects the firm's performance that provides the researcher to make the study on this topic.

Review of Literature

Chandler (1975) stated in his study, "It is almost ridiculous to have to justify the importance of a strong majority of outside directors. It is true that the board must steadfastly represent the stockholders in making a continuous evaluation of the CEO's performance, then a board of predominately outsiders logically follows". Conyon and Peck (1998) conclude that the effect of board size on corporate performance (ROE) is generally negative. Limiting the board size is believed to improve firm performance because the benefits of larger boards are outweighed by the poorer communication and decision making of larger groups (Lipton and Lorsch, 1992). Bhagat and Black (1999) discussed the trends in proportion of independent directors vis-à-vis the total no. of directors of large American public companies since 1960 and revealed that independence of directors, board size, CEO ownership, outside director ownership are independent variables and are found related with profitability and growth variables over a period. The results did not find any proof that independence of board enhances the firm's performance.

Forberg (1989); Hermalin and Weisbach (1991); Lin (1996) depicted that there is no evidence that more outsiders on board improve firm's performance as per Agrawal and Knoeber (1996). Further Brown & Caylor (2004) and Ho (2005) revealed the conclusions in their studies that there is a strong and positive correlation between non-executive directors and corporate performance. Ryan and Wiggins (2004) recommended that boards with outside members award the directors with higher levels of equity-based compensation, which in turn reduces the agency costs.

Survey of 515 Korean firms by Black et al. (2005) showed that firms with 50% outside directors have 0.13 higher Tobin's, which is consistent with the view that greater board independence casually predicts higher share prices in emerging markets. Haniffa and Hudiab (2006) argued that the market perceives multiple directorship as unhealthy, and do not add value to corporate performance. Smaller board size improves the firm's performance. Chhaochharia and Grinstein (2007) found that large firms tend to have a larger fraction of independent directors than smaller firms. Garg (2009) also concluded that smaller board are more efficient than large ones and recommended the size of six to attain better performance. Biswas and Bhuiyan (2008) found that size of boards has no significant impact on corporate governance disclosure.

M Lamport J, Latona M N, Seetanah B and Sannassee R V (2011) showed that on the overall, there is no difference in performance for companies having poor and excellent quality of governance.

Omolara Ojulari (2012) concluded in his study that audit committee effectiveness do have an impact on a firm's value but the degree of the impact differs from profitability to investors confidence and also whether on individual or collective basis.

The bulk of empirical literature revealed that board independence enhances the firm's performance and larger size of boards not always put positive results, all of this provides the scope for further research to researcher in this regard which aims at exploring the relationship between board's independence, size and firm's profitability.

Objectives of the study

- To know the relationship between numbers of directors and firm's performance.
- To find whether there is a relationship between directors' independence and profitability.

Research Methodology

Being study exploratory as well as descriptive in nature, it will go through collection and analysis of data, of both types, primary to explore the relationship between corporate governance & firm's profitability and secondary to describe the theoretical concepts. Being the population in large, sampling method has been used instead of census method. BSE listed companies excluding the financial sector companies because of their governance from different regulations. Data has been collected through annual reports, company's websites, official websites of SEBI. Five years data has been taken starting from financial year 2007 to 2012. Regression model has been used to measure the impact of the corporate governance on firms' performance. Furthermore validity of the results has been tested with ANOVA.

Hypotheses:

H₁: Board of Directors' size has significant positive impact on firm's profitability.

H₂: Independence of directors has significant positive impact on firm's profitability.

- 1) **Parameters of the Study:** Various parameters have been specified as key variables to be taken into account to draw concrete conclusions from the study, which are as follows:-

a) **Corporate Governance Parameters/Variables**

- i. Size of Board of Directors ii. Independent directors

b) **Firm's Profitability Parameters/Variables**

- i. Price Earning (P/E) Ratio iii. ROI (Return on Investment)
ii. Net Profit Ratio iv. Tobin's Q

- c) **Control Variables:** Results of the study are subject to control for a no. of variables as below:-

- i. Longevity of Firm iii. Executive's Approach
ii. Market Risk (β) iv. Financial Leverage
v. Size of Firm (in terms of log of sales) vi. Form of Enterprise/Ownership Structure

- 2) **Regression Model:-**

Firm's Profitability = $\alpha_0 + B_1$ (Board Size) + B_2 (Executives' Approach) + B_3 (Size of Firm) + B_4 (Market Risk) + B_5 (Longevity of Firm) + B_6 (Financial Leverage) + B_7 (Ownership Structure) + E (Error Term).....(1)

$$\text{Firm's Profitability}_i = \alpha_0 + B_1(\text{Independence of Directors}) + B_2 (\text{Executives' Approach}) + B_3 (\text{Size of Firm}) + B_4 (\text{Market Risk}) + B_5 (\text{Longevity of Firm}) + B_6 (\text{Financial Leverage}) + B_7 (\text{Ownership Structure}) + E (\text{Error term}). \dots\dots\dots(2)$$

The four profitability variables have been taken together in the equations.

Results and Discussions

Table I explained the correlation results between size of board of directors and independence of directors with reference of four profitability variables.

Table I: Correlation between Board Size and Profitability Variables

Parameters	N.P. Ratio	ROI	P/E Ratio	Tobin's Q
Size of Board of Directors	0.01	-0.039	-0.16*	-0.13*
Director's Independence	0.17*	0.05	0.18*	0.26*
* Significant at 0.01 level (i.e. 1% level)				

Table I reveals that the board size has a significant and negative impact on price-earning ratio and Tobin's Q, which proves that small size of board enhance the firm's profitability. But director's independence is positively and significantly related with all the profitability measures, except return on capital employed. It indicates that independent directors are capable to take better decisions, consequently firm's profitability increases.

Table II: Regression Results

		Dependent Variables			
		N.P. Ratio	ROI	P/E Ratio	Tobin's Q
Independent Variables	Board Size:				
	Intercept	Not	Not	2.455 (6.218)	6.853
	co-eff (β)	Significant	Significan	-0.412 (-2.679)	(-6.491)
	R ²		t	0.079	-0.599 (2.79)
				0.217	
	Independence of Directors:				

Intercept	0.089	Not	1.39 (4.342)	4.670
co-eff (β)	(2.501)	Significan	0.968 (3.482)	(5.183)
R^2	0.113	t	0.109	2.091
	(2.098)			(3.256)
	0.089			0.492

Values in parentheses are being stated in Table III.

Note: Regression has been run taking age, size, leverage, executive's approach, ownership structure & β for market risk as control variables.

Table III: Results of ANOVA

Variables	Size of Board of Directors				Independence of Directors			
	Mean Squares		F-Value	Sig. Level	Mean Squares		F-Value	Sig. Level
	Between Groups	Within Groups			Between Groups	Within Groups		
Time Period	9.01	12.049	0.747	0.576	0.019	0.029	0.655	0.617
			Not Significant				Not Significant	
Executives' Approach	80.187	11.650	6.877	0.001	0.062	0.024	2.459	0.085
			Significant				Not Significant	
Market Risk	49.98	4.469	11.039	00	0.084	0.013	6.184	00
			Significant				Significant	
Financial Leverage	51.3	4.68	10.96	0	0.079	0.013	6.152	00
			Significant				Significant	
Size of Firm	13.14	14.1	0.931	0.695	0.032	0.045	0.696	0.801

			Not Significant				Not Significant	
Ownership Structure	149.99	10.149	14.778	0	.125	0.022	5.68	.001
			Significant				Significant	
Firm's Longevity	11.983	12.74	.943	0.298	.15	0.025	6.01	.001
			Not Significant				Not Significant	

As Table III states the results of ANOVA, which indicates that the variation between size of board directors and independence of directors is not significant based on time period. But significant variation has been found for board size with different categories of executives. The results also show that there is no significant variation in director's independence on the basis of various categories of executives. It has also been proved that different categories of market risk and level of leverages have the significant impact on both board size and independence of directors. Ownership structures were also found to have the effect on size as well as independence of directors. The age and size of firm have no significant impact on board size and director's independence. Overall H_1 has been proved false whereas H_2 is true.

Conclusions

Study strongly denies statistically significant relationship between size of board of directors and profitability variables i.e. P/E Ratio and Tobin's Q. On the other hand, director's independence has a positive and significant impact on firm's profitability, except Return on Investment (ROI), provided size, longevity, market risk, financial leverage, executive approach and form of enterprise (ownership structure) are controlling factors. Present study recommends that size of board of directors should be small because large boards consume more times in decision making and its execution but it should not be too small to function properly. Out of two factors i.e. board size and board's independence, the second factor i.e. director's independence has been found key factor that should be more emphasized. So, firm's performance in terms of profitability lies in quality and efficiency of independent directors.

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Abbreviations

P/E Ratio: Price Earnings Ratio

ROI: Return on Investment

N.P Ratio: Net Profit Ratio

