

**CRANFIELD UNIVERSITY**

**Ramji Poudel**

**Corporate Governance and Firm Performance:  
Evidence from India**

**Cranfield School of Management  
Doctoral Program**

**PhD Thesis  
Academic Year: 2012-2018**

**Supervisors:  
Prof. Sunil S. Poshakwale  
Dr. Vineet Agarwal**

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## **Abstract**

Corporate governance (CG) has attracted much public interest in the last three decades because of its apparent importance for the financial health of corporations, for the economy, and society in general. Most prior studies have focussed on CG issues in developed economies, particularly in the USA, UK, and other European countries, arguing that the advanced economies have relatively resolved their CG problems. CG issues are rooted in the separation of ownership and control of corporations with widely diffused ownership structures and managerial controls that result in agency problems between owners and managers. CG models of these advanced economies have been branded as the international benchmark for the best practices.

Emerging economies are rising to become global economic superpowers. Many of them are newly liberalized, but in a short period, they have been overtaking advanced economies in terms of sizes and growth rates. CG problems in emerging economies are manifest via the concentration of ownership, prevalence of family control, and pyramidal ownership structures having entirely different institutional contexts for CG structures. However, little is known about the impact of CG on firm performance in emerging and developing economies. To understand the evolving perspective of CG in emerging economies, I look at India. This thesis is organized in paper format with three journal papers.

Paper 1 describes the evolving perspective of CG in India. Its first part analyses the evolution of CG in India in three stages: the managing agency model (in the colonial period until 1947); the conglomerates or business house model (1947-1991); and the Anglo-American model (after 1991). My analysis shows that the modern form of CG in India evolved with the economic liberalization of 1991. Since then it has gone through several reform processes with well structured CG laws, regulations and codes, such as Clause 49 of the Listing Agreements, the Corporate Governance Voluntary Guidelines 2009, the Companies Act 2013, and the Insolvency and Bankruptcy Code of India 2016. These CG laws, guidelines and codes are intended to provide a strong CG environment

in the country, so that it can resolve CG problems and strengthen the financial health of corporations.

The second part of the paper compares CG systems in India with those of the USA and UK in six areas, i.e. CG regulatory frameworks, board structures and committees, ownership structures, stakeholder relationships, financial accounting, auditing and reporting practices, and markets for finance. Initially, the CG systems in India were closer to the UK's business-based CG model of 'comply or explain', but after the Companies Act 2013, Indian CG systems moved closer to the US regulations-based CG model of 'comply or die'.

Paper 2 discusses how performance indicators, such as Tobin's Q, returns on assets (ROA) and returns on equity (ROE), are affected by a company's leadership styles, and by its board's size, independence, compensation, and gender diversity, plus its directors' age, tenure, activities, and external commitments. From a sample of around 150 large Indian companies for five years from 2010/11 to 2014/15, listed on Bombay Stock Exchange (BSE) and National Stock Exchange (NSE), I construct a panel data, and I use system-generalized methods of moments (system GMM) on fixed effects regression models. The regression results show that board independence has a negative association with all performance indicators because of the lack of unified and prudent decisions. Directors' tenure positively affects Tobin's Q and ROA, implying that long-serving directors are good stewards of firms' resources. CEO duality negatively affects Tobin's Q, suggesting that the concentration of both the decision-making role and supervisory role in a single individual does not improve firm performance. Boardroom gender diversity is negative with ROA and ROE, which implies that companies appoint women directors as tokens to comply with the laws. Board size, external commitments, compensation and activities have no significant association with performance indicators. Past performance, as measured by one year lag of performance variables, are positive with the current year's performance, implying that there is a dynamic effect on firm performance.

In Paper 3, I empirically examine the components of ownership structure, as the key elements of internal governance mechanisms of the companies. Components of

ownership structure, such as institutional ownership, promoter groups' ownership, proportions of promoter directors, blockholders' dispersion, family control, directors' property, and government ownership are examined by linking them with firm performance, Tobin's Q, ROA and ROE. In an unbalanced panel data of 150 large Indian companies, I use system GMM estimation on fixed effects regression models. I find that equity ownership of institutional investors has a positive impact on Tobin's Q, indicating that institutional investors are independent, and they do not compromise as monitors of the firm. Family control improves firms' accounting performances, as indicated by positive associations between family control and ROA and ROE. These results suggest that family control lowers agency problems between owners and managers and also does not adversely affect the interests of minority shareholders. Family members in family-controlled firms act as stewards instead of agents, and their behaviour improves firm performance.

Similarly, ownership by promoter or promoter groups' positively affects market performance as measured by Tobin's Q. Higher percentage of ownership gives the promoters enough incentive and control to monitor managerial activities. Non-executive directors' (NEDs) ownership has a negative association with ROA and ROE. NEDs, who hold a nominal proportion of ownership stake of the firms, are neither active directors nor fully independent, which can damage firm performance. Blockholders' dispersion has a positive relationship with Tobin's Q and negative association with ROA and ROE. These results suggest that markets react positively to the presence of multiple blockholders; however, multiple blockholders are damaging accounting performance due to the presence of a new set of conflicts among blockholders, and between large blockholders and minority shareholders. Government ownership of companies has no significant association with performance measures.

Keywords:

Corporate governance, board of directors, ownership structure, India, US, UK, Tobin's Q, ROA, ROE

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## List of abbreviations

|         |                                                                 |
|---------|-----------------------------------------------------------------|
| ADR     | American Depositary Receipt                                     |
| BCCI    | Bank of Credit and Commerce International                       |
| BRICKTS | Brazil, Russia, India, China, Korea, Turkey, and South Africa   |
| BSE     | Bombay Stock Exchange                                           |
| CII     | Confederation of Indian Industry                                |
| CLERP   | Corporate Law Economic Reform Program                           |
| CNBC    | Consumer News and Business Channel                              |
| DGCL    | Delaware General Corporation Law                                |
| DIN     | Directors Identification Number                                 |
| ERISA   | Employee Retirement Income Security Act                         |
| FASB    | Financial Accounting Standard Board                             |
| FCA     | Financial Conduct Authority                                     |
| FDI     | Foreign Direct Investment                                       |
| FID     | Foreign Independent Director                                    |
| FII     | Foreign Institutional Investor                                  |
| FPI     | Foreign Portfolio Investment                                    |
| FRC     | Financial Reporting Council                                     |
| FTSE    | Financial Time Stock Exchange                                   |
| GBL     | Gender Balance Law                                              |
| GMM     | Generalized Method of Moments                                   |
| IBC     | Insolvency and Bankruptcy Code                                  |
| ICAI    | Institute of Chartered Accountants of India                     |
| ICAI    | Institute of Cost Accountants of India                          |
| ICSI    | Institute of Company Secretaries of India                       |
| IMF     | International Monetary Fund                                     |
| LSE     | London Stock Exchange                                           |
| MCA     | Ministry of Corporate Affairs                                   |
| MVC     | Market Value Capitalization                                     |
| NASDAQ  | National Association of Securities Dealers Automated Quotations |
| NED     | Non-Executive Directors                                         |
| NFCG    | National Foundation for Corporate Governance                    |
| NSDL    | National Securities Depository Limited                          |
| NSE     | National Stock Exchange                                         |
| NYSE    | New York Stock Exchange                                         |
| OECD    | Organization for Economic Cooperation and Development           |
| PIO     | Person of Indian Origin                                         |
| PIS     | Portfolio Investment Scheme                                     |
| RBI     | Reserve Bank of India                                           |
| SEBI    | Securities Exchange Board of India                              |
| SOX     | Sarbanes Oxley Act                                              |
| UNCTAD  | United Nations Conference on Trade and Development              |
| WEF     | World Economic Forum                                            |

# Chapter 1: Introduction

## 1.1. Introduction to corporate governance

Research on corporate governance (abbreviated CG) has burgeoned over a decade or two (Aguilera and Jackson, 2010), generating much interest among academics, economists, investors, policymakers and business communities (Kadyrzhanova and Rhodes-Kropf, 2011). Several events are responsible for the heightened interest in CG, for example, the crisis in 1998 in Russia, Asia, and Brazil (Claessens and Yurtoglu, 2012), and the high-profile financial scandals and corporate collapses around the world in the 1990s and early 2000s<sup>1</sup> (Brown and Caylar, 2006; Dalton and Dalton, 2011). The unseemly remuneration paid to executives and the celebrity status of CEOs has created unprecedented public interest in CG (Weisbach, 2007). These corporate failures, financial scandals and economic crises have shown how CG failures can damage corporations and entire economies, and can adversely affect global financial stability (Claessens and Yurtoglu, 2013). Many countries have called for “major corporate governance reforms to restore investor confidence in publicly traded firms by creating a system of greater control over managerial actions” (Brown and Caylor, 2009: 129), and some countries, such as Turkey, have introduced partial reforms and made some changes in aspects of CG (Claessens and Yurtoglu, 2012). Nevertheless, these reforms can be useful for understanding the importance of CG for economic development and wellbeing.

Claessens and Yurtoglu (2013) further suggest the structural reasons for the importance of CG and its reform. First, the private, market-based investment process is much more important for most economies, and this process is underpinned by means of strong CG frameworks. Second, with the increase in size, scale and scope of businesses, the roles of financial intermediaries and institutional investors (both domestic and international)

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<sup>1</sup> For example, Maxwell, Global Crossing, Tyco International, Adelphia Communications, Merrill Lynch, Enron, Arthur Anderson (auditing firm of Enron), Quest Communications, HealthSouth, and WorldCom. These high-profile corporate failures in the global capital markets in the 1990s and early 2000s have elicited vigorous debate on CG and concerted efforts for CG reform (Anderson et al., 2007).

have been increased enormously. The mobilization of capital is more complicated because of the availability of investment alternatives with the opening up and liberalization of financial and real markets. And corporate sectors have increasing exposure to market forces risks because of some structural changes in economies such as price deregulation and competitions. Companies with poor CG are vulnerable, and failures in CG can ruin the companies themselves as well as the national and global economic stability.

According to Mallin (2019), good CG is important for companies to ensure adequate and appropriate system to control and safeguard company assets; it prevents individuals from having too much power and influence; it maintains appropriate relationships between management, board of directors, shareholders, and other stakeholders; it aims to ensure that companies are managed in the best interests of owners and other stakeholders; and it aims to ensure transparency and accountability in management and corporate performance, in which investors are keenly interested (pp. 10).

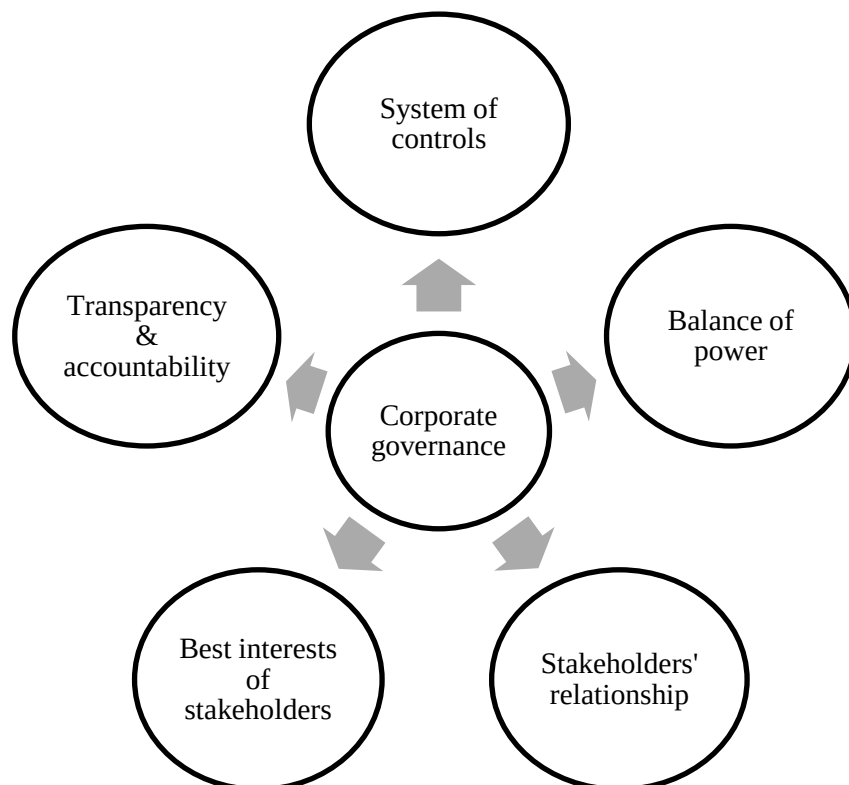


**Figure 1.1: Importance of corporate governance**

## **1.2. Definition of corporate governance**

The term corporate governance can be defined as “the system by which companies are directed and controlled” (Cadbury Committee, 1992). CG is a set of mechanisms through which companies are operated. CG concerns power and influence over decision-making within the corporation. It describes the relationships between parties with a stake in the firm and how their impact on strategic corporate decision making is shaped by institutions in different countries (Aguilera and Jackson, 2010). In the words of Turnbull (1997), “Corporate governance describes all the influences affecting the institutional processes, including those for appointing the controllers and/or regulators, involved in organizing the production and sale of goods and services”.

In a seminal paper, Shleifer and Vishny (1997) wrote that “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. This definition considers CG as the measure of protecting the interests of suppliers of funds, i.e. investors and creditors. CG system is the combination of several mechanisms which ensure that the management runs the corporations for the benefits of several stakeholders. On the one hand there are external mechanisms for corporate control, such as legislation which imposes responsibilities on boards, executives and auditing firms, and on the other hand there are internal control mechanisms, such as a board of directors that shapes firm-level governance, to ensure that firms are run effectively and maximise shareholder and/or stakeholder value (Aguilera, 2005).

CG is a set of rules and institutional arrangements for wielding power over several stakeholders’ interests; a good CG mechanism maintains a proper balance of power. It identifies who has power and accountability, and who makes decisions. It holds down agency costs that accompany the specialization of organizational functions that arise from the separation of ownership and control (Baysinger and Butler, 1985). A good CG system is essential for the corporate success which ultimately enhances corporate value and profitability.

## **1.3. How does corporate governance affect firms?**

Claessens and Yurtoglu (2013) identified five channels through which CG impacts corporations, particularly in emerging market economies.

**Easy access to financing:** With potentially profitable opportunities for growth, firms often find themselves wondering whether to use their internal resources of finance or to seek to raise funds from external resources (Chen et al., 2010). Firms with better CG have access on better terms to capital markets, both domestic and cross-border, which is valuable for firms intending to grow (Shleifer and Vishny, 1997; Doidge et al., 2007). Firms with better CG can arrange funds from countries where investor protection is higher. For example, firms can list their shares for trading in the USA by initiating an American Depository Receipt (ADR) program. Better CG ensures more financial transparency and information disclosure to reduce information asymmetry between insiders and outsiders, leading to reduced agency costs of financing (Nguyen et al., 2015). Moreover, by investing in CG, even firms facing high agency costs may be able to obtain easier access not just to debt but also to equity markets (Mande et al., 2012).

**Higher firm value and performance:** Better CG ensures better performances by ensuring the appropriate use of resources, enabling access to financing at favourable terms and improving investors' confidence (Denis and McConnell, 2003). Through effective monitoring and control mechanisms, a better CG framework prevents expropriation of company resources and improves decision making. Mande et al. (2012) argue that the quality of CG reduces overall costs of financing investment opportunities, reduces information asymmetry between suppliers of finance, and discourages management entrenchment. This makes firms more attractive to investors, leads to growth and adds value by improving performance through more efficient management, better asset allocation, better labour policies, and other efficiency improvements (Claessens and Yurtoglu, 2013).

**Less stock price volatility:** The quality of CG frameworks can affect firm behaviour during economic ups and downs. Good CG leads to more consistent performance and stock prices. For example, Mitton (2002) find that firms with weaker CG lost relatively more value during the East Asian financial crisis of 1997-98, and Lemmon and Lins (2003) find that under-performance was -20 per cent worse for businesses with weak

CG than for other firms during the East Asian financial crisis. Gompers et al. (2003) report a strong association between the quality of CG and the stock returns. Firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, and lower capital expenditure, and made fewer corporate acquisitions.

**Better functioning of financial markets and greater cross-border investments:** The quality of CG in a country affects the functioning of its financial and capital markets and the level of cross-border investment activities. According to Cadbury (2000), international investing institutions and global capital markets are causing some CG convergence with international standards. Cross-border investments by institutional investors are channelling to those countries which meet the disciplines of transparency and financial reporting and control, board effectiveness, and equal treatment of all shareholders. Expansion of investing activities starts to tap more resources from international financial and capital markets. Also, the quality of CG in terms of investor protection laws and the degree to which they are enforced affect the size and functioning of countries' capital markets (Denis and McConnell, 2003).

However, many emerging markets have common weaknesses in their financial and capital markets development. Governments still control or influence banks and financial institutions. Financial resources are allocated not based on free-market competition but based on governments' strategic priorities. Also, the capital markets in emerging countries are subject to weak oversight, long regulatory delay, weak investor protection, and ultimately high capital raising costs (Fan et al., 2011).

**Better stakeholder relations:** Besides their owners and management, businesses must deal with several stakeholders such as banks, creditors, employees, regulatory authorities, and so on. Each of the stakeholders wants to monitor, discipline, motivate and affect the management and the firm in various ways (Claessens and Yurtoglu, 2013). According to Zingales (1998), CG is the complex set of conditions that determine the quasi-rents (profits) generated by the firm in the course of relationships with stakeholders and shape the bargaining over them. This statement refers to the determination of value-added by firms and allocations of added value among different stakeholders related to the firms are done as per the set rules, as well as institutions, i.e.

CG mechanisms. CG ensures accountability of managers/directors to the public who have an interest in the activities of a corporation. It aims to maximize the contribution of firms to the overall stakeholders as well as to the economy (Branston et al., 2006). Freeman (2010) argues that the bottom line for the stakeholder relations has to be the set of transactions that managers in organizations have with stakeholders. Allocation of resources and interaction with stakeholders is a matter of justice: how the value added by the business is allocated in the manner due to recipients (Greenberg and Bies, 1992). A good CG framework aims to maintain stakeholder relationship by distributive justice, providing outcome satisfaction (e.g. corporate social responsibility), and procedural justice, providing system satisfaction, i.e. dealing with the processes through which decisions are made (e.g. corporate social responsiveness) (Greenberg, 1990).

#### **1.4. Corporate governance in emerging economies**

Emerging economies are the developing and newly industrializing countries with rapid economic development, widespread economic liberalization and free-market systems (Hoskisson et al., 2000) and with growing significance in the world economy (Singh, 2003). Emerging economies constitute about half of the global gross domestic product, exports from emerging markets make up 45 per cent of world trade (IMF 2017 database)<sup>2</sup>, and 80 per cent of the world's population (Hoskisson et al., 2005). The significance of emerging markets in the world economy has become increasingly important (Singh, 2003; Hoskisson et al., 2005). However, it is argued that emerging economies are characterised as having weak legal institutions for CG (Johnson et al., 2000), under-developed and imperfect capital markets, and informational and regulatory shortcomings (Singh, 2003). With the projection of strong economic growth in emerging markets over the next decade, the World Economic Forum (WEF)<sup>3</sup> in 2016 points the necessity for the immediate development of deep and liquid capital markets to fund future growth and to ensure the competitiveness of those economies globally.

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<sup>2</sup> Available at [www.imf.org/external/pubs/ft/weo/2019/01/weodata/weoselagr.aspx#a200](http://www.imf.org/external/pubs/ft/weo/2019/01/weodata/weoselagr.aspx#a200), (Accessed 8 May 2019)

<sup>3</sup> Available at [www.weforum.org/docs/WEF\\_accelerating-capital-markets-development-in-emerging-economies.pdf](http://www.weforum.org/docs/WEF_accelerating-capital-markets-development-in-emerging-economies.pdf), (Accessed 9 May 2019)

According to WEF, emerging markets need strong CG frameworks to broaden the investor base by improving the investor value proposition via reforms that encourage both foreign and domestic investors to flow the resources and strengthen regulatory and legal frameworks for their better protection.

From the late 80s and early 90s, many emerging economies, including India, began liberalizing their economy, which was driven not only by political and social changes in the world but also by economic imperatives and pressures from institutions such as the IMF and World Bank (Kale and Anand, 2006). The economic liberalizations provide foreign investors with the opportunity to invest in the domestic market and domestic investors in foreign markets (Bekaert et al., 2003).

Since the economic liberalization that was started in 1991, India's economy looks in many ways like a success story. India has been achieving higher economic growth, which has been fuelled by strong macroeconomic outcomes, improved infrastructure, increased outsourcing activities by western companies, and increased consumption appetite of India's fast-growing, large middle-class population (Poshakwale and Thapa, 2010), and also by the surged foreign direct investment (FDI) and foreign portfolio investment (FPI). Now, India has been recognized as the most dynamic and among the fastest-growing emerging economies in the world having GDP growth rates of 7.4 per cent in 2014/15, 8.2 per cent in 2015/16, 7.1 per cent in 2016/17, and 6.7 per cent in 2017/18. The GDP growth rates are projected to be 7.3 per cent and 7.5 per cent for 2018/19 and 2019/20, respectively. The United Nations Conference on Trade and Development (UNCTAD) survey ranked India as the third most favourite host country for foreign direct investment (FDI) in 2017/18 after the USA and China. The gross FDI inflows to India during FY 2017/18 stood at US\$ 60.97 billion; a ten-fold increased from US\$ 6.05 billion of 2004/05, which were US\$ 60.22 billion in 2016/17, US\$ 55.56 billion in 2015/16, and US\$ 45.15 billion in 2014/15 (Source: RBI<sup>4</sup>).

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<sup>4</sup>*Foreign Investment Inflows*. Reserve Bank of India (RBI). Available at <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=statistics>, (Accessed 10 May 2019).

Similarly, foreign portfolio investors (FPIs) worldwide believe that India is an attractive investment destination among emerging markets. The cumulative foreign portfolio investments in India, as of 10 May 2019, reached to INR 1,275,452 crore (i.e. US\$ 182.2 billion)<sup>5</sup> (Source: NSDL<sup>6</sup>). These huge amounts of FDIs and FPIs are the evidence that investors around the world are keen and optimistic about the favourable investment environment in India. Hence, as well as being fundamental to investor confidence, a good CG is essential to attracting new investment, particularly for emerging countries where a good CG is often seen as a means of attracting FDI at more favourable rates (Mallin, 2019).

Although there are a number of studies on the issues related to CG around the world, most studies are predominantly based on advanced economies, for example, Mehran (1995), Core et al. (1999), Coles et al. (2001), Gompers et al. (2003), Cremers and Nair (2005), Core et al. (2006), Judge et al. (2008), and Bebchuk et al. (2009). Most advanced economies, for example, the United States, Germany, Japan, the United Kingdom (Shleifer and Vishny, 1997), and most of the European and OECD member countries, have resolved their CG problems at least reasonably well (Klapper and Love, 2004). However, the advanced economies-centric analyses can be important for countries with similar institutional settings (such as economic and political systems, and capital markets) but not for other economies with different institutional contexts (Bebchuk and Weishach, 2010).

Notwithstanding the importance of emerging economies in the world economy is higher; the state of CG in emerging economies is not clear due to the lack of empirical studies on various aspects of CG such as roles and characteristics of the board of directors, ownership structure and their impacts on firm efficiency and performance. Emerging economies lag far behind the developed economies in terms of research in economics and finance (Fan et al., 2011). Remarkably, little is known about the firm-

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<sup>5</sup> The currency exchange rate 1 US\$ = INR 70.01 as of 10 May 2019.

<sup>6</sup> *FPIs/FIIs Investment Details*. NSDL. Available at <https://www.fpi.nsdl.co.in/web/Reports/Yearwise.aspx?RptType=5>, (Accessed 10 May 2019).

level CG practice in emerging economies (Klappar and Love, 2004; Balasubramanian et al., 2010; Black et al., 2010).

## 1.5. Thesis structure

This thesis is structured as three journal-type articles or papers, based on the sample of large companies from an emerging economy, India, linking firm-level CG practices with financial performance. To some extent, these papers intend to fill the academic void in measuring the effectiveness of CG in emerging economies. A brief outline of the thesis is provided in Table 1.1 below:

**Table 1.1: Thesis structure**

| Chapter | Paper | Title                                                             | Intended contributions                                                                                                                                                                          |
|---------|-------|-------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1       | -     | Introduction                                                      | The topic of interest and thesis structure.                                                                                                                                                     |
| 2       | -     | Aims and Objectives                                               | Aims and objectives of the individual papers.                                                                                                                                                   |
| 3       | 1     | Corporate governance in India and a comparison with the US and UK | Describes the development of CG systems in India and identifies how the Indian CG model resembles or differs from the Anglo-American model.                                                     |
| 4       | 2     | Board characteristics and firm performance: evidence from India   | The impact of board characteristics on firm performance in the context of changing CG regulations in India particularly after the issuance of ‘Corporate Governance Voluntary Guidelines 2009’. |
| 5       | 3     | Ownership structure and firm performance: evidence from India     | Provide the evidence of how ownership structure and CG mechanisms relate to firm performance in an emerging economy.                                                                            |
| 6       | -     | Contributions, limitations and future research                    | Summary. Shows the coherence of the work done, points out the limitations, and suggests areas for future research.                                                                              |

Formatting this thesis as a series of papers, rather than a monograph, offers several advantages. First, individual papers can be separate chapters. Second, they provide valuable experience in writing concisely. Third, the chapters are ready-made first drafts of articles to submit to academic journals.

## **Chapter 2: Aims and Objectives of the Research**

### **2.1. Aims and objectives**

The overall objective of this research thesis is to examine the relationship of CG practices with firm performance in an emerging economy, India. The thesis has produced three research papers including- 1) Corporate governance in India and a comparison with the USA and UK; 2) Board characteristics and firm performance: evidence from India; and 3) Ownership structures and firm performance: evidence from India. The specific aims and objectives of each paper are explained in separate points below:

1. There has been a flow of program of legislative and regulatory reforms in India during the past three decades by the government agencies and non-government professional organisations. Most of these efforts have been directed towards bringing the CG standards in India closer to international standards of good practices. The aims of Paper 1 (chapter 3) are, first, to provide a coherent evolution of CG in India. By doing so, the paper attempts to identify gaps in the country's CG laws and regulations and one can hope that these gaps would be addressed over time so that India's standing as one of the most favourable investment destinations among investors around the world can be further strengthened.

Next, the paper compares and contrasts the Indian CG system with the USA and UK systems. Most of the studies in comparative CG use the US/UK CG model as the benchmark for international comparison (Jackson and Moerke, 2005; Aguilera and Jackson, 2010; Conyon and Shipilov, 2012: pp.71). The aim of the comparison between Indian CG system with the USA and UK systems is to determine to what extent the CG framework in India is aligned with international baseline models and how the CG practised in India is different from the US and UK practices.

2. The characteristics and compositions of board of directors are the key components of internal CG mechanisms in emerging markets, like in India, where the external mechanisms of corporate control are less efficient and effective. Hence, Paper 2

(chapter 4) aims to evaluate the Indian CG systems by linking the characteristics and composition of the board of directors with the firm performance. The evaluation is done in the context of regulatory changes, particularly, after the introduction of ‘Corporate Governance Voluntary Guidelines 2009’, which has issued several CG codes related to the composition of the board of directors, such as board leadership style, directors’ remuneration, directorships of directors, directors’ tenure, and directors’ independence. Listed companies are expected to comply with the Codes or to explain if not complied with. The paper assesses whether the Codes can address the CG issues and enhance firm performance in India.

3. The ownership structure and control of corporations and the institutional set-up in which such corporations are operated determine the nature of firm-level CG problems. The Indian corporate sector is characterised by concentrated ownership and control in the hands of family and family groups. At the same time, ownership structure, as one of the key internal governance mechanisms, is widely considered to mitigate CG problems both in widely-held firms and in those firms with concentrated ownership and control (Sarkar, 2012, pp. 217). The objective of Paper 3 (chapter 5) is to examine the ownership structures and their impacts on firm performance of listed companies in India. The paper considers the characteristics of corporate ownership in India, such as the increasing stakes of both domestic and global institutional investors and the prevalence of state ownership in a significant number of listed companies.

The characteristics and composition of the board of directors and ownership structures are components of the internal mechanisms of CG. The board of directors is the apex of internal control systems and charged with advising, monitoring, hiring, firing, and compensating the management team (Jensen, 1993). Ownership structure includes internal and external ownerships, and the locus of control depends on whether the ownership is concentrated or dispersed, or on whether the owners are promoters or families or institutions. Owners are the residual claim-holders, and they exercise control over the firms using their voting rights and bear all agency costs (Craswell et al., 1997). Hence, the board of directors and ownership structure are two separate components of

firm-level CG structures (Gillan, 2006). These components, to some extent, can be the best alternatives where external mechanisms of corporate control are absent or ineffective (Morck et al., 2005; Young et al., 2008). Paper 1 provides a CG framework in India and the state of Indian CG compared to the US/UK. The other two papers, i.e. paper 2 for board characteristics and firm performance, and paper 3 for ownership structure and firm performance, provide the firm-level CG practices and their impacts on value and profitability in India.

## **2.2. The key elements of the papers and findings**

### **2.2.1. The key elements of the thesis**

This sub-section provides some key elements of the thesis with a brief overview of the findings. The CG in India is presented in three papers. The first part of paper 1 describes the evolving perspective of CG in India, beginning with the historical background. The CG reform process was initiated as a response to increasing demands for shareholder protection, legitimate pressures to the government for economic liberalization, and the presence of foreign institutional investors. The paper also summarizes the contributions made by government authorities and professional bodies. The second part of the paper compares Indian CG systems with the USA and UK in six different areas, i.e. legal frameworks, board structure and committees, ownership structure, stakeholder relationship, financial accounting, auditing and reporting practices, and markets for finance. The extant literature has neglected the comparative study of CG systems among these countries, so there is no idea how the governance system in India resembles the governance systems of the USA and UK.

A country's CG mechanisms can be internal (such as the board of directors, ownership structure, managerial incentives, and, so on) and external (such as laws and regulations, financial and capital markets, and, so on) (Gillan, 2006). In this study, two internal CG mechanisms, i.e. characteristics and composition of the board of directors and ownership structure, are investigated. Paper 2 and Paper 3 provide empirical evidence of the association of CG mechanisms with performance indicators based on a sample of large companies in India. The companies were selected from 200 largest companies

listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) for five years from 2010/11 to 2014/15. The size of a company was determined by the market value capitalization (MVC). The sample size was further reduced to 150 by excluding financial institutions and removing companies with incomplete data. Data related to firm performance, MVC, leverage, and total assets were collected from Datastream. Data related to the board of directors and ownership structures were collected manually from BoardEx, CNBC moneycontrol.com, Yahoo Finance India, and companies' annual reports and websites. An unbalanced panel data has been constructed having 753 firm-years observations.

Endogeneity is the major issue in the analysis of the governance-performance relationship. Some authors, e.g. Bascle (2008), Larcker and Rusticus (2010), Semadeni et al. (2014) suggest how to use the instrumental variable technique to minimize the effects of endogeneity. However, the problematic aspect of the instrumental variable estimation is the difficulty in identifying suitable instruments to obtain the correct output (Semadeni et al., 2014). Following the approach of Wintoki et al. (2012), Abdallah et al. (2015), and Gippel et al. (2015), in both papers, the system generalized method of moments (system GMM) estimation is used. The system GMM estimation relies on the internal instruments within the panel data itself and corrects all types of endogeneity. The regression models developed in both papers were robust (as indicated by VIFs confirmed non-multicollinearity, Hansen tests legitimized the instrumental variables, Wald  $\chi^2$  test showed the fit of the models, and Arellano-Bond (AR1 and AR2) tests confirmed no serial autocorrelation and second-order autocorrelation).

### **2.2.2. Key findings**

Paper 1 highlights the state of CG in India by describing the evolution of CG, showing the importance of CG in an emerging country like India, and comparing and contrasting the CG systems in India with the USA and UK. The analysis shows that the CG reform in India was initiated with the economic liberalization in 1991, which opened its market and corporate sectors for global institutional investors. With the anticipation of an increase in foreign investments, the country has brought gradual changes in its CG systems by introducing several voluntary and mandatory CG codes and rules. The

Security Exchange Board of India (SEBI) and the Ministry of Corporate Affairs (MCA), as the regulators of CG in India, have issued Corporate Governance Voluntary Guidelines 2009 (based on a 'comply or explain' approach), the Company Act 2013 (with several mandatory CG rules), and Clause 49 of the Listing Agreement for all security exchanges (more aligned with the CG rules of the Company Act 2013).

Initially, the Indian CG model resembled the UK soft approach of 'comply or explain' (e.g. Corporate Governance Voluntary Guidelines 2009 of India follows the Combined Code of the UK), which is also known as the business-driven model of CG. After the enactment of the new Company Act 2013, it is more aligned with the US hard approach (e.g. Sarbanes Oxley Act 2002), known as the regulatory-driven model of CG. However, the Indian CG provisions, in terms of board characteristics such as board leadership style, board independence, directorships of directors, directors' tenure and age, and boardroom gender diversity, are different from those of the USA and UK. It implies that India has embedded some unique CG mechanisms as per her institutional context.

Paper 2 examines the impacts of characteristics of the board of directors on firm performance in a sample of large Indian companies listed on BSE and NSE, particularly after the issuance of the Corporate Governance Voluntary Guidelines 2009. Board characteristics variables include CEO duality, board independence, board busyness, directors' remuneration, board activities, and boardroom gender diversity, and firm performance variables include market performance (Tobin's Q) and accounting performance (ROA and ROE). The paper finds that board independence has adverse effects on all forms of firm performance, which is beyond the claim of those who advocate for board independence. Board size, board busyness, directors' remuneration, and board activities have no significant association with firm performance variables. CEO duality has a negative relationship with market performance but has no relationship with accounting performance. Boardroom gender diversity has a negative association with accounting performance. The law mandates a board seat for woman directors in all the listed companies in India. However, appointing only one woman director on the board as a token seems to be inexpedient as they will be categorized, stereotyped and ignored by the majority of the male directors.

Paper 3 examines the ownership structures as the means of CG affecting the firm performance of listed companies in India. The study is important, as the ownership structures are changing because of the globalization of Indian companies, finance, and capital markets. The components of ownership structures include institutional ownership, family control, promoter groups' ownership, non-executive directors' ownership, the proportion of promoter directors on board, blockholders' dispersion, and government ownership, and firm performance includes a market performance measure (Tobin's Q) and accounting performance measures (ROA and ROE).

The study finds that institutional ownership is positively associated with Tobin's Q but is not associated with ROA and ROE. Family control has a positive association with accounting performance (ROA and ROE) but has no association with market performance (Tobin's Q). Promoter groups' ownership is positive with Tobin's Q but is not associated with ROA and ROE. The ownership stake of non-executive directors has no association with Tobin's Q but has a negative association with ROA and ROE. The proportion of promoter directors on the board of directors and government ownership do not relate to all forms of firm performance. Blockholders' dispersion is positively associated with Tobin's Q and negatively associated with ROA and ROE.

Theoretically, better CG practices should have a positive relationship with firm performance. However, my papers analyzing the relationship of CG practices, in terms of board characteristics and ownership structure with firm performance, provide mixed results that some variables show a positive relationship, some show a negative. In contrast, others show that there is no significant relationship between CG and firm performance.

## **Chapter 3: Corporate Governance in India and a Comparison with the USA and UK**

### **Abstract**

Several aspects of Indian CG practices are highlighted, then compared and contrasted with CG practices in the USA and UK. Origins, compliance, the board of directors and committees, ownership pattern, financial accounting, reporting and auditing practices, and markets for finance are compared.

The origin and development of modern CG in developed countries have been driven by corporate scandals and failures, such as the financial collapse of BCCI and Maxwell Corporation in the UK, and the collapse of Enron, WorldCom, Tyco, and Adelphi due to accounting scandals in the USA (Agrawal and Chadha, 2005). In India, the modern CG developed in parallel with the economic liberalization and transformation, which opened the Indian market and corporate sector to global institutional investors. The country has brought gradual changes in its CG systems to attract and hold more foreign direct investment and foreign portfolio investment, and to align its CG with international best practices. Also, some financial scams, such as the Harshad Mehta and Ketan Parekh scams, and accounting malpractice, such as the Satyam Computer scam, forced the Indian regulatory bodies to expedite the CG reform process in the country.

UK CG codes are voluntary (e.g. UK Combined Corporate Governance Codes) and largely business-driven. The US CG codes combine both voluntary and mandatory code provisions, which is also known as business-driven as well as regulatory-driven, e.g. Sarbanes-Oxley Act 2002. Whereas, in India, CG codes were initially voluntary (e.g. the Corporate Governance Voluntary Guidelines 2009) and now have converged with the US style of regulatory-driven (e.g. the Companies Act 2013). Indian corporate sectors now have several mandatory rules and laws for their governance with mechanisms to ensure effective compliance and enforcement. Promoters, promoter groups and families control many Indian listed companies. Also, a significant number of companies are controlled by the state and federal governments, which heavily influence

the appointment of CEOs, boards of directors, and strategic decision-making processes. Hence more stringent CG standards are essential to protect minority shareholders, restore investor confidence, and conform with national socio-economic interests.

Keywords:

Corporate governance, CG Codes, Clause 49 of Listing Agreement, Voluntary Guidelines 2009, the Companies Act 2013, India, USA, UK

### **3.1. Introduction**

CG reform in India is the deliberate outcome of the country's economic liberalization, initiated in the 1990s (Jackling and Johl, 2009). Since then, as suggested by Aguilera and Cuervo-Cazurra (2004), two parallel processes such as globalization (i.e. the liberalization and internationalization of economies, developments in communications, and the integration of capital markets) and transformation in the ownership structure of firms (resulted from the growth of domestic and foreign institutional investors, privatization of SOEs, and rising shareholder activism), have increased the need for strong monitoring mechanisms and appropriate incentive schemes to improve CG systems. During India's economic transformation process, the deregulation of capital markets was quickly followed by a series of corporate scandals and capital market frauds (Jameson et al., 2014), which caused financial and capital market crashes. These events created challenges of transparency and trusts among firms, regulators, investors, and the general public (Narayanswamy et al., 2012). The country faced intense pressures for changes in CG which led to the convergence of various CG practices toward a more market-based and shareholder-oriented model of governance. The Government and industry-led professional bodies are called to bring changes in the CG system of listed companies in India.

The modern form of CG in India was not inadvertent but has developed gradually with the pace of global movement towards CG reforms. The code of good governance in the USA in 1978 (the first territory to issue CG Codes), Hong Kong in 1989 (the second territory), the Cadbury Report 1992 in the UK (third) (Aguilera and Cuervo-Cazura, 2009), the Organisation for Economic Cooperation and Development (OECD) Code in 1999, the Sarbanes-Oxley Act 2002 in the US, the Combined Code in the UK, Australia's CLERP 9 in 2004 also became motivation for the Indian Government, regulatory bodies, private sector and professionals to bring gradual changes in CG laws, rules, codes and practices in India (Jackling and Johl, 2009).

The Security and Exchange Board of India (SEBI), Ministry of Corporate Affairs of the Government of India (MCA), and Confederation of Indian Industry (CII) have made significant contributions to the CG reform process by forming several committees to

constitute CG regulations and guidelines. During this process the CII brought out 'The Desirable Corporate Governance: A Code' in 1998; the SEBI brought out 'Clause 49 of the Listing Agreement' in 2000; (subsequently amended in 2004, 2006 and 2014), and the MCA introduced 'Corporate Governance Voluntary Guidelines 2009' and a new Companies Act in 2013. Many governance practices were adopted by companies only after 2004, especially those which became legally required from the amendment of Clause 49 of the Listing Agreement in 2004, such as requiring companies to have a code of conduct for directors and executives, disclosure of related-party transactions, policies on insider trading, and so on (Balasubramanian et al., 2010; Chauhan et al., 2016).

The legal framework for CG in India is primarily inherited from English Common Law traditions, but with the increasing globalization of the Indian economy, the country's CG provisions are, now, aligned more closely with international standards and practices (Dharmapala and Khanna, 2013). Indian legal requirements in some areas like board structure, disclosure, board procedure, and related party transactions are sufficiently strict, and over-compliance with such provisions are costlier and not producing any valuable gains to the companies (Narayanswamy et al., 2012). Notwithstanding the strong legal provisions for CG from the regulatory authorities, repeated financial scandals and dishonest corporate behaviour time and again help to cast some doubt on effective enforcement and monitoring of CG rules developed over the period. As argued by Balasubramanian et al. (2010), government enforcement actions against firms for non-compliance with CG rules are almost nonexistent. However, the current scenario has been changing. The Government of India enacted a new Companies Act 2013 with mandatory CG laws, amended Clause 49 of the Listing Agreement in 2014, matched equity listing rules with the Companies Act, and introduced the Insolvency and Bankruptcy Code 2016 (IBC 2016) intending to introduce new provisions in resolving insolvency in India. The country also has enacted the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 to strengthen the legal enforcement of contracts. By enacting these laws and codes, India is expected to perform very well in protecting minority investors, enforcing contracts, and resolving insolvency. The country's corporate law and securities regulations have been

recognized as highly advanced, and that ranks India in fourth place in the global ranking in 2018 on protecting minority<sup>7</sup>.

The paper aims to highlight the CG scenario in India because the country offers an exciting avenue for the study of CG provisions and practices as it has completed several steps in CG reform process. All the provisions for CG mechanisms have been amended and incorporated in the form of Codes of Practices, Voluntary Guidelines, Equity Listing Agreements, and new Company Acts. As argued by Narayanswamy et al. (2012), Indian CG is more aligned with international best practices by moving towards a more market-based and shareholder-oriented model of governance. This paper aims to compare and contrast the Indian CG arrangements with those of the USA and UK. To a remarkable extent, the USA and the UK remain an implicit benchmark for international comparison. CG reforms around the world are often informed by the principles underlying the Anglo-American model of CG, which is characterized by short-term equity finance, strong shareholder rights, dispersed ownership, an active market for capital control, and flexible labour markets (Jackson and Moerke, 2005; Aguilera and Jackson, 2010). Hitherto, comparative work among UK, USA and India has been neglected. It is a pity since, although there are important similarities, there are also differences that have not been thoroughly investigated. Hence, the following research questions are proposed:

*What are the corporate governance systems in India? How are they similar to or different from the US and UK systems?*

This paper contributes to the CG literature in two ways. First, it provides a brief overview of CG reforms in India. It expands the understanding of the CG regime in India by describing a coherent development of CG codes, rules and regulations parallel to the economic transformation in the country. Second, the comparison of Indian CG systems with US/UK systems helps to determine whether India has refined her CG systems to fit her realities and provides opportunities for further refinement by adopting

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<sup>7</sup> See The World Bank Press Release on 31 October 2017. Available at <https://www.worldbank.org/en/news/press-release/2017/10/31/india-jumps-doing-business-rankings-with-sustained-reform-focus>. (Accessed 23 May 2019).

positive aspects of Anglo-American models. No country takes for granted the pure CG models directly imported from the USA or UK or any other country. Instead, the best CG models are further embedded with local requirements before they are adopted by other countries (Aguilera and Jackson, 2010).

Section 3.2 describes the background of CG in India. Section 3.3 describes its historical evolution, showing the initiatives of government authorities and private, professional bodies. Section 3.4 compares CG in the USA, UK and India. Section 3.5 is the final summary.

## **3.2. Theoretical Framework**

Modern CG discussions originated from the traditional agency problem, which arises from the separation of ownership and control, a common feature of today's corporation (Jensen and Meckling, 1976). Traditional agency theory emphasizes the role of CG as ensuring that the firm operates in the best interests of shareholders (Fama and Jensen, 1983). The agency theory is seen as overly narrow as the focus is on one stakeholder group (shareholders) in isolation of other groups (Judge et al., 2008). It does not take into account of other stakeholders' interests and influences on corporations' performance (Filatotchev and Boyd, 2009). Also, this theory is almost solely based on a single institutional setting of Anglo-American governance systems and most of the research on CG oriented on this theory focus exclusively on accountability, in order to minimizing the risk to shareholders, and enabling management to operate corporations in order to assure that shareholders benefit the most (Filatotchev and Wright, 2005). However, different countries in which research are conducted may have the different institutional environment, and that may lead to differences in the nature and extent of agency problems on the firm level which may impact the outcome (Ahrens et al., 2011). Aguilera and Jackson (2003) argue that traditional agency theory is unable to accurately compare and explain for cross-country diversity of CG arrangements across different institutional contexts.

The institutional environment is the set of fundamental political, social and legal ground rules that establishes the basis for the functioning of the corporation. Within this

environment, institutional arrangements are made between economic units that govern how these units can cooperate and/or compete (Williamson, 1990). The author further notes that the top and senior managers act as designers of the governance structure with the ultimate aim to reduce transaction costs. According to North (1989), institutional arrangements consist of informal constraints, formal rules, and the degree and effectiveness of enforcement of the rules which provide the basic structure in which the corporations perform. All social actors are seeking legitimacy and/or reinventing legitimacy norms within the institutional environment. He further argues that the institutional change is an incremental process, in which the short-run profitable opportunities cumulatively result in creating the long-run paths of institutional change. The current state of a system is determined not only by its initial conditions but also by the path it took (North, 1990; 2005). Changes in any aspect of these, either the informal codes of conduct or formal rules or in improving the enforcement of rules will change the firm performance.

The institutional theory may be useful in framing the study of CG reform and cross-country comparison of CG systems. This theoretical framework suggests that the CG problems outlined by the agency and shareholders perspectives must be challenged to better capture the patterned variation in CG that results from interdependences between firms and their environment. The traditional agency theory is unable to acknowledge the roles and interdependences of various institutions (Filatotchev and Boyd, 2009; Aguilera et al., 2008). The institutional theory is a holistic approach that takes account institutional environments in shaping organizational forms and practices.

The evolutionary path of the governance system of a country is the result of several individual historical events and policy responses to them (Yoshikawa and Rasheed, 2009). The Institutional theory addresses the issue of how and why organizational structures and processes have been evolved. It places great emphasis on environmental norms and the social influence beyond the control of the organization as explanations of its actions and outcomes (Hung, 1998). The institutional theory integrates the convergence-divergence viewpoints of CG systems (Yoshikawa et al., 2007). In one side, it explains the isomorphism of CG systems because of the pressure of economic and social globalization that will inevitably converge the CG system of a country on the

Anglo-American template (Coffee, 1999). On the other side, the national models of CG will exist despite the pressure of economic and social globalization, reflecting social embeddedness, institutional complementarities and path dependence (North 1990; Bebchuk and Roe, 1999).

According to Globerman et al. (2011), “One needs to understand the rationale for and consequences of specific corporate governance models, as well as the likelihood that specific governance reforms will be adopted and prove effective” (pp. 1). The institutional theory allows one to understand how the national institutions, such as ownership structure or the enforceability of CG regulations, tend to enable as well as constrain diverse CG mechanisms (Aguilera, 2005). Grounding on institutional theory framework, the paper analyses the evolution of CG systems in India and compares the Indian CG systems with the USA and UK to uncover the convergence or divergence of Indian CG systems to the Anglo-American systems.

### **3.3. Background of corporate governance reforms in India**

The move towards the CG reforms in India started with the economic reforms of 1991 “in the wake of an exceptionally severe balance of payment crisis” (Ahluwalia, 2002: pp. 67). Before 1991, the Indian economy had acquired a reputation as one of the most protected and heavily regulated economies in the world (Kotwal et al., 2011). The economy was characterized mainly by a socialist way of central planning, limited role of the private sector, and governed by strict sets of licensing requirements, permits and quotas for industrial production (Soo, 2008; Narayanswamy et al., 2012). Eventually, in the 1980s and 90s, the economy faced a severe fiscal crisis, the foreign currency balance was only just enough for two weeks’ imports, and the national currency was massively devalued (Singh and Gaur, 2009).

Beating the fiscal crisis became an urgent priority of the Government, which approached the IMF and the World Bank for financial assistance (Pederson, 2000; Kotwal et al., 2011). The IMF put forward economic restructuring (liberalization) as a pre-condition for their assistance to India. The World Bank and IMF injected money into the Indian economy for structural adjustment and to usher in a comprehensive

liberalization programme. Subsequently, the Government embarked on significant policy changes to reform the economy, which came as a surprise to many observers (Pedersen, 2000). “The economic reforms that started since July 1991 emphasized on the liberalization and development of the financial sector to supplement the efforts aimed at achieving high economic growth in India” (Singh, 2008: pp. 1615). The Government’s initiative was described as a movement from an interventionist approach towards economic liberalization (Mukherjee-Reed, 2002), with steps towards a more open economy with greater reliance upon market forces, a more significant role for the private sector including foreign investment, and a restructuring of the role of Government (Ahluwalia, 2002).

Notwithstanding that a few tentative steps in the mid-1970s and then later in the 1980s were taken to liberalize the regulatory regime in India, not surprisingly, CG was not a major concern of business entrepreneurs or the governments. With the extensive economic liberalization in 1991, the foreign investment started to increase and CG has become an issue of great importance to both Indian businesses and the government (Kotwal et al., 2011). The governance reform has twin objectives; it must promote confidence in distant investors and it must also promote for better firm performance. Since then, there have been further a wide range of policy changes in diverse sectors, all aimed at opening up the economy to private sector entrepreneurs as well as to welcoming foreign trade and investment. Due to the changes in laws and regulations, India witnessed a significant transformation in its economy, corporate sector, and CG landscape (Chakrabarti et al., 2008).

The modern form of CG in India has not developed overnight. Starting from a non-existent scenario of CG, the reform journey has followed the path dependence nature of CG arrangements with gradual and rigorous processes over time. If CG were to change toward more efficient forms, cross-national diversity would be unlikely to exist and continue over long periods (Aguilera and Jackson, 2010). Despite the Indian CG system is now considered more converged with the international best practices, there is still possibility that Indian corporate structures and CG rules can be path dependent, creating and maintaining clear differences from other countries.

### **3.4. Evolution of corporate governance in India**

The evolution of CG in India, as noted by Mukherjee-Reed (2002), can be categorised in three historical stages: the managing agency model in the colonial period (until 1947); the conglomerates or business house model (1947 – 1991); and Anglo-American model (after 1991). Before independence in 1947, Indian corporations were bound by colonial rules and regulations. With independence, India inherited one of the poorest economies but with a legal system based on English common law, which offered, in principle, relatively better protection of investor rights, and better developed financial markets than other independent countries had (LaPorta et al., 1998; Chakrabarti et al., 2008; Jameson et al., 2014). For example, the Indian Companies Act was already introduced in 1866 and gradually revised in 1982, 1913 and 1942, the Bombay Stock Exchange was established in 1875, and the Indian Partnership Act was enacted in 1932. However, practical enforcement was not effective, and the judicial system had limited resources and long delays (Jameson et al., 2014). During that period, corporate affairs of business focussed on the managing agency model (Sharma, 2012), which was established by merchant families for a quick turnover of capital and to allocate a small quantity of capital to a large number of ventures (Mukherjee-Reed, 2002). That would allow them to promote new companies and hold on to control over them. They used to earn profit not from innovation or productivity but rather from inflation, intermediation, and trade in imperfect and incomplete markets. The managing agency model eventually established the structural basis for the strong family-controlled conglomerate or business-house model that started to dominate the Indian corporate sector for an extended period.

Immediately after independence in 1947, the Government introduced the Industrial Policy Resolution of 1948 (which was comprehensively revised in 1956, 1973, 1977, 1980 and 1991), and the Industries (Development and Regulation) Act of 1951. The Indian Parliament also enacted the Companies Act of 1956. These Acts and Regulations required all businesses to be registered with government departments; and to obtain a licence for any business start-up, expansion, or new products. In these Acts, the Government reserved its rights to regulate price, supply and distribution of products in

certain industries; to investigate companies in the event of noncompliance and to take over their management. This period was also known as the 'Licence Raj', a system of complex industrial licensing requirements for business (Soo, 2008; Goldberg et al., 2010). The Government had adopted an interventionist approach, state-planned socialist economy, and protection of the domestic business. Hence, the domestic business promoters (families) remained central players in the Indian corporate sector and contributed to the rise of powerful conglomerates (business houses).

In principle, the above Acts aimed to accelerate the speed of industrialisation, support both the private and public sectors, and achieve higher economic growth and employment. However, they deviated far away from these objectives; as many corporate houses thrived during this period but brewed a severe macroeconomic crisis (Reed, 2002; Mukherjee-Reed, 2002). Critics seriously alleged that the Indian economy had been 'hijacked' by a few Indian business houses and politicians. The Government initiated economic reform in 1991 with the assistance of the World Bank and IMF, which produced remarkable changes in the institutional framework of CG in India, such as liberalization of capital markets, adoption of a takeover code paving the way for the development of a market for corporate control, and improvement in CG norms and disclosure practices (Douma et al., 2006). The process involved amendment of the Companies Act providing shareholders' sovereignty and several policies to reform financial and banking sectors, trade, foreign investment, and industrial sectors. The reform process forced the Indian corporate sector to embrace the Anglo-Saxon model of governance. The Anglo-Saxon model of CG is characterised by diffused ownership; control vested in boards of directors, with external directors playing an important role; a liquid capital market; a developed market for corporate control and takeover; and more defence of ownership rights of shareholders over the rights of debtholders (Cuervo, 2002).

CG reform was not only triggered by the economic liberalization, but also by the spate of big financial scandals, such as the Harshad Mehta financial scam in 1992, the Bombay stock market crash during the first flush of economic liberalization (Goswami, 2000; Mallick et al., 2007; Chaturvedula et al., 2015); the Ketan Parekh scam of 2000, a market collapse due to the rigging of share prices (insider trading) of a private bank

prior to its merger by creating a nexus with its promoter (Giannikos and Gousgounis, 2012; Jain and Sunderman, 2014); and the failure of Satyam Computers in 2009. Those scams badly damaged investors' confidence and impacted negatively on the development of the primary market, which triggered the needs for maintaining transparency and building trust among business organisations, investors and the public. Eventually, the Government, regulators, and concerned private sectors demanded mechanisms for disclosure and transparency of the corporate sector and protect investor interests.

The Security and Exchange Board of India (SEBI) and the Ministry of Corporate Affairs (MCA) of the Government of India are considered the primary regulators of Indian CG. They have undertaken several initiatives in CG reform. The Confederation of Indian Industry (CII), a non-government, not-for-profit industry-led and industry-managed organization, also has been playing a proactive role in the governance reform process. The CII was the front runner in forming a task force to develop CG codes before any initiative taken by the SEBI and MCA and still has been actively contributing to the development of Indian CG. A timeline mapping of key initiatives taken for the development of CG in India is summarized below:

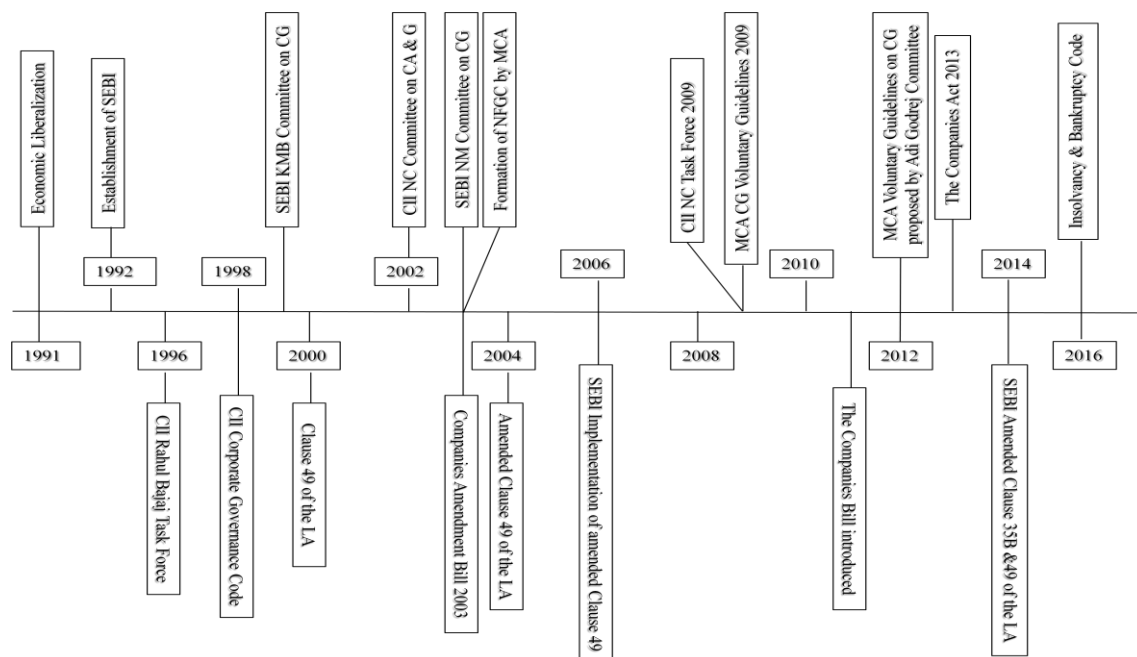


**Figure 3.1: Timeline of corporate governance reforms in India**

## **Establishment of the Securities and Exchange Board of India (1992)**

The Securities and Exchange Board of India (SEBI) was established on 12 April 1992, under the provisions of the Securities and Exchange Board of India Act, 1992. In its preamble, SEBI describes its primary functions as, “...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto” ([www.sebi.gov.in](http://www.sebi.gov.in)). The establishment of SEBI has been regarded as the milestone in CG reform in India. SEBI honoured the advocacy and pressures from corporate industry groups and initiated a significant reform process in Indian CG. As an independent regulator, SEBI monitors and regulates CG of listed companies in India through Clause 49 of the Listing Agreement, which resembles the US Sarbanes-Oxley Act 2002 (Claessens and Yurtoglu, 2013).

## **National Task Force Chaired by Rahul Bajaj in 1996 and the Desirable Corporate Governance: A Code in 1998**

Before the initiatives of SEBI, in 1996, the Confederation of Indian Industry (CII) took a special effort on CG by forming a national taskforce led by Rahul Bajaj. The purpose of the task force was, “to develop and promote corporate governance codes to be adopted and followed by Indian companies, be these in the private sector, the public sector, banks or financial institutions.” The task force published its final CG code ‘The Desirable Corporate Governance: A Code’ in April 1998. This path-breaking initiative by CII was to address the growing “public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry; the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry.” In the Code, CII made seventeen voluntary recommendations in five areas of CG:

- Board of Directors: single-tier boards, a combination of executive and non-executive directors, directorships of directors, the role of non-executive directors

and their remuneration, attendance requirement for reappointment of directors, key information to the board, and audit committee;

- Desirable Disclosures: information to shareholders, compliance certificate to be signed by the Chief Executive and Finance Officers, quantity and quality of disclosure;
- Capital Market Issues: allow greater funding to the corporate sector against the security of shares and other paper;
- Creditors' Rights: debt covenants, credit ratings, restriction in dividend declaration if a company goes default; and
- Financial Institutions and Nominee Directors: reduce the number of nominee directors and increase competent officers.

The Code issued by CII became the basis for subsequent official initiatives for the development of CG rules and laws (Narayanswamy et al., 2012).

### **The Kumar Mangalam Birla Committee on Corporate Governance (1997) and Clause 49 of the Listing Agreement (2000)**

In the wake of the East Asian Financial Crisis of 1997, SEBI formed Kumar Mangalam Birla Committee, to promote and raise the standards of CG of listed companies, which recommended significant changes in the listing requirements of stock exchanges. The Committee submitted its recommendations in 2000 and, based on them, SEBI issued a new clause, namely Clause 49 of the Listing Agreement. The Clause has made mandatory and non-mandatory recommendations about the CG of listed companies, including –

- Board of directors: to have 50 per cent of non-executive directors (NEDs) and independent directors (IDs), and to disclose any pecuniary relationships or transactions of NEDs;
- Audit committee: to be set up with NEDs and IDs, minimum three meetings a year, power and roles of the audit committee, functioning as the law requires;
- Remunerations of directors: remunerations of NEDs to be decided by the board, disclosure of all components of remuneration packages of all directors;

- Board procedure: at least four board meetings in a year, maximum of ten directorships for a director, maximum five chairmanships for the chairman;
- Management: A Management Discussion and Analysis report on Annual Reports, disclosures of all material financial and commercial transactions;
- To shareholders: provide details of directors to be appointed or re-appointed, quarterly reports, Shareholders/Investors Grievance Committee to be formed for any complaints;
- Report on Corporate Governance: disclose a detailed compliance report on CG in a separate section of Annual Reports; in case of non-compliance, the companies need to explain them with the reasons. Also, they are required to highlight the extent of adoption and non-adoption of non-mandatory recommendations; and
- Compliance: obtain a CG compliance certificate from the auditors.

### **The Naresh Chandra Committee on Corporate Audit and Governance (2002) and Amendment of the Companies Bill in 2003**

Following the corporate accounting scandals in the USA between 2000 and 2002<sup>8</sup> and the enactment of the Sarbanes-Oxley Act 2002<sup>9</sup>, the Ministry of Corporate Affairs (MCA) of the Government of India formed a high-level committee in August 2002, namely the Naresh Chandra Committee (NCC) on Corporate Audit and Governance, to make recommendations mainly on corporate audit practices. The Committee made several recommendations related to disqualifications for audit assignments, such as direct relationship with the company to be audited, any business relationship with the client, or a personal relationship with a director; list of prohibited non-audit services; compulsory audit partner rotation; auditor's disclosure of contingent liabilities; auditor's

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<sup>8</sup> Between 2000 and 2002, the USA witnessed an avalanche of corporate accounting irregularities in a number of large companies such as Adelphia Communication, AOL Time Warner, Arthur Andersen, Bristol-Myers Squibb, CMS Energy, Duke Energy, Enron, Global Crossing, Kmart, Homestore.com, Merck, Halliburton, Dynegy, El Paso, Mirant, Tyco, Reliant Energy, Qwest Communications International, WorldCom, and Xerox.

<sup>9</sup> The Sarbanes-Oxley Act 2002, a US federal law, enacted by the US Congress that aims to regulate particularly public accounting firms which audit companies and to protect investors by improving the accuracy and reliability of corporate disclosures. The Act also provides new CG standards for companies' managements and boards of directors.

disclosure of qualifications and consequent action; management's certification in the event of auditor's replacement; auditor's annual certification of independence; appointment of auditors; setting up of independent quality review board; disciplinary mechanism for auditors; independent directors on audit committees of listed companies; and audit committee charter. Besides, it recommended preventing auditing firms from providing non-audit services to clients and requiring that the CEO and CFO of listed companies certify to, and take responsibility for, the fairness and correctness of their company's annual audited accounts. The Committee also recommended for the board size, definition of independent directors, percentage of independent directors, and training to independent directors. These recommendations have been formalized by including them in the Companies (Amendment) Bill in 2003 and subsequently, the Companies Act 1956 was amended.

#### **The Narayan Murthy Committee on Corporate Governance (2003) and Amendment of Clause 49 of the Listing Agreement (2004)**

The Narayan Murthy Committee on Corporate Governance was formed by SEBI in 2003 to suggest measures to improve CG standards of listed companies. It made several recommendations for amendment of Clause 49 of the Listing Agreement including:

- Provisions to strengthen the responsibilities of audit committees;
- Improved quality of financial disclosures, requiring assessment and disclosure of business risks in the annual reports of companies by executive boards;
- Making boards responsible for adopting formal codes of conduct and introducing the position of nominee directors; and
- A requirement of stockholders' approval and improved disclosures relating to non-executive directors' compensation.

The Committee report also includes provisions for independent directors, related party transactions, CEO/CFO certification, quarterly compliance reports, risk management, directorships and director compensation, financial disclosures, and a whistleblower policy. The SEBI amended and circulated the revised Clause 49 of the Listing Agreement to all the Stock Exchanges in 2004.

### **Formation of a National Foundation for Corporate Governance (NFCG) in 2003**

The Ministry of Corporate Affairs established a National Foundation for Corporate Governance (NFCG) in October 2003 with the vision to “be a catalyst in making India the best in corporate governance practices”, in association with the Confederation of Indian Industries (CII), the Institute of Company Secretaries of India (ICSI), and the Institute of Chartered Accountants of India (ICAI). They expanded NFCG in 2010 by including the National Stock Exchange (NSE) and the Institute of Cost Accountants of India (ICAI). The NFCG aims to provide a platform to corporate stakeholders (corporate leaders, policymakers, regulators, law-enforcing agencies and non-government organizations) to deliberate on issues relating to good CG, to encourage voluntary compliance, and to create awareness among corporate leaders of the importance of good CG practices, as well as to facilitate exchange of experience and ideas among corporate stakeholders. It also aims to work to create a framework of CG best practices, best structure, best processes, and ethics. NFCG has developed an action plan to develop principles of good CG norms for institutional investors, independent directors, and auditing ([www.business.gov.in](http://www.business.gov.in)). However, this committee and its reports never received the attention and publicity that they deserved; hence, their initiatives have mainly remained unnoticed and relegated to the archives of the MCA (Balasubramanian and Satwalekar, 2010: pp.4).

### **Issuance of Corporate Governance Voluntary Guidelines 2009**

Despite several initiatives to improve CG in India, they failed in preventing the spectacular failure of Satyam Computer Services Limited, a leading company that had more than a third of Fortune 500 companies as its clients, with a workforce of 53,000 and operations in 66 countries, in 2009 (Atenci et al., 2010; Narayanswamy et al., 2012). The company suffered a scam of approximately US\$ 1 billion and had been inflating earnings and assets over eight years period by systematically falsifying its accounts which went undetected (Rishi and Singh, 2011; Craig et al., 2013).

The Satyam scandal revealed a need for transparency and mutual trust among stakeholders. It raised questions on CG issues related to authorities and responsibilities

of the board of directors, representation on the board of directors, independence of directors, auditors, and compensation committee, and relations between boards and executives (Dash, 2012). The scandal raised serious questions about the implementation of CG norms in India. To address these issues and recommend further improvements in CG standards and practices, CII formed a task force under the chairmanship of Naresh Chandra in February 2009. At the same time, the Ministry of Corporate Affairs activated NFCG to provide a platform to deliberate on issues relating to good CG and sensitize corporate stakeholders on the importance of good CG practices so that the spillover effects of the Satyam scandal could be minimized.

In December 2009, the MCA issued Corporate Governance Voluntary Guidelines 2009 embodying the recommendations of Naresh Chandra Task Force set up by CII. The MCA expected sincere efforts of the listed companies in the adoption of the guidelines that “would result in creating a system of transparent and accountable corporate functioning”. In the preamble to the Guidelines, the MCA hoped that “by following good governance practices, the Indian corporate sector would be in a better position to enhance not only the economic value of enterprise but also the value for every stakeholder who has contributed in the success of the enterprise, and while doing so, it would be setting the global benchmarks for good corporate governance”.

### **The Companies Act 2013**

The long-awaited Companies Bill was passed by the Indian Parliament, and received the President’s assent on August 2013, to become the Companies Act 2013. The Act is a culmination of several years’ brainstorming on how to shape corporate law in India and to completely supersede the Companies Act of 1956 that had been governing the corporate sector in the country for nearly six decades. It is a landmark legislation that incorporates important changes in the provisions related to governance, e-management, compliance and enforcement, disclosure norms, auditors, and mergers and acquisitions, which have far-reaching implications and will bring significant changes in how the corporate sector operates in India (PwC, 2013). The following is a summary of the key CG provisions for listed companies in Companies Act 2013 and Companies Act 1956:

## Key CG provisions in Companies Act 2013 compared to Companies Act 1956

| Provisions                                 | Companies Act 1956                                                                                                                                               | Companies Act 2013                                                                                                                                                                                                                                                                        |
|--------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Woman director</b>                      | No provision for woman director.                                                                                                                                 | Companies shall have at least one woman director. (Ch. XI: 149(1))                                                                                                                                                                                                                        |
| <b>Number of directors</b>                 | Minimum 3 and maximum 12. (Ch. II: 252(1) & 259(B))                                                                                                              | Minimum 3 and maximum 15. (Ch. XI: 149(1) & (3))                                                                                                                                                                                                                                          |
| <b>Maximum number of directorships</b>     | 15 directorships (w.e.f 31.12.2000, prior amendment it was 20). (Ch. II: 275)                                                                                    | 20 directorships, the maximum number of public companies in which a person can be appointed as a director shall not exceed 10. (Ch. XI: 165(1))                                                                                                                                           |
| <b>Directors' independence:</b>            | No provision for directors' independence.                                                                                                                        | Companies shall have at least one-third of their total directors as independent directors. (Ch. XI: 149(4))                                                                                                                                                                               |
| <b>Separation of CEO and Chairman Role</b> | No provision for separation of CEO and Chairman role.                                                                                                            | An individual shall not be appointed or re-appointed as the chairperson, as well as the managing director or CEO of the company at the same time unless a) the articles of such a company provides otherwise, or b) the company does not carry on multiple businesses. (Ch. XIII: 203(1)) |
| <b>Director Identification Number</b>      | Every individual intending to be appointed as a director of a company shall make an application to the Central Government for allotment of a DIN (Ch. II: 266A). | Not changed. (See Ch. XI: 152(3) & (4))                                                                                                                                                                                                                                                   |

|                                                 |                                                                                                                                                                                                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|-------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b><i>Rotation of directors</i></b>             | At every AGM, one-third of the directors are liable to retire by rotation (Ch. II: 256(1)).                                                                                                                                                                   | Not changed. (See Ch. XI: 152(6))                                                                                                                                                                                                                                                                                                                                                                                                               |
| <b><i>Term of independent director</i></b>      | No provision of independent directors.                                                                                                                                                                                                                        | An independent director shall hold office for a term up to five consecutive years on the Board of a company; a special resolution should be passed for his/her re-appointment to the Board. No independent director shall hold office for more than two consecutive terms, but such director shall be eligible for appointment after the expiration of three years from ceasing (cooling period) to be an independent. (Ch. XI: 149(10) & (11)) |
| <b><i>Directors' age</i></b>                    | 25-70 years (Schedule XIII: (c))                                                                                                                                                                                                                              | 21-70 years (Ch. XIII: 196(3) (a))                                                                                                                                                                                                                                                                                                                                                                                                              |
| <b><i>Directors from small shareholders</i></b> | A listed company may have one director elected by small shareholders. (Ch. II: 252)                                                                                                                                                                           | Not changed. A listed company may have one director elected by small shareholders (a shareholder, holding shares of the nominal value of not more than INR 20,000). (Ch. XI: 151)                                                                                                                                                                                                                                                               |
| <b><i>Audit Committee</i></b>                   | Every public company (with a minimum paid-up capital of five crore rupees) shall constitute an Audit Committee consisting of a minimum of three directors of which two-thirds shall be directors, other than managing or whole-time directors. (Ch. II: 292A) | Mandatory for all listed companies. Every listed company shall form an Audit Committee consisting of a minimum of three directors with independent directors in the majority. The majority members of the Audit Committee, including its chairperson, shall be able to read and understand the financial statement. (Ch. XII: 177(1) & (2))                                                                                                     |

|                                                     |                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-----------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b><i>Appointment of Auditors</i></b>               | Every company shall, at each AGM, appoint an auditor or auditors and can be re-appointed at each AGM (Ch. II: 224(1)). Must be a Chartered Accountant (Ch. II: 226(1)). The Act does not specify the maximum term of an auditor or audit firm.  | Every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor. The maximum term allowed to be appointed or re-appointed as an auditor for an individual is one term of five consecutive years, and for an audit firm is two terms of five consecutive years. They will not be eligible for re-appointment as an auditor in the same company for the next five years. (Ch. X: 139) |
| <b><i>Nomination and Remuneration Committee</i></b> | No provision for Nomination and Remuneration Committee. But amended in February, 2011 that every listed company shall have a Remuneration Committee consisting of at least three non-executive independent directors. (Part II: Section II (D)) | Every listed company shall form a Nomination and Remuneration Committee consisting of at least three non-executive directors, minimum one-half of which shall be independent directors. (Ch. XII: 178(1), (2) & (3))                                                                                                                                                                                                        |
| <b><i>Stakeholders Relationship Committee</i></b>   | No provision for Stakeholders Relationship Committee.                                                                                                                                                                                           | The Board of Directors of a company having more than 1,000 shareholders, debenture-holders, deposit-holders or any other security holders at any time during a financial year shall form a Stakeholders Relationship Committee consisting of a chairperson who shall be a non-executive director. (Ch. XII: 178(5) & (6))                                                                                                   |

### **Amendment of Clause 49 of the Listing Agreement in 2014**

The SEBI incorporated Clause 49 as an important set of governance reforms (Balasubramanian et al., 2010) in the equity listing agreement in February 2000 to promote and raise the standards of CG of listed companies in India. The Clause made several mandatory and non-mandatory governance provisions for companies. Some key provisions made by the Clause were on directors' independence, audit committee and its composition and independence, companies to have remuneration committees, ensuring shareholders' access to information, obtaining a compliance certificate from the auditor, and including a separate section as the report on CG in annual reports. The Clause has been periodically amended in 2004, 2006, and recently in 2014 effective from 1 October 2014.

The Companies Act 2013, a primary corporate law with several CG provisions for companies, has minimum expectations of governance applicable to all companies. Accordingly, CG norms have been amended and issued by SEBI in 2014, as Clauses 35B and 49 of the Listed Agreement. The Listing Agreement expects listed companies to comply with provisions of the Companies Act 2013 and simultaneously to adopt the best CG standards and make their governance framework more effective. The CG Codes by SEBI requires companies to be more transparent on board-related matters and to incorporate changes in the roles and responsibilities of the board, board committees, and directors' independence, disclosures of information, and mandatory compliance on several CG provisions. The CG Codes recognise the BODs as a vital link between ownership structure and senior management and therefore have a critical role and responsibility in the overall governance of the corporate sector. Transparency, self-reporting and disclosures are the key features of the Companies Act 2013 and Clause 49 of the Listing Agreement.

### **Insolvency and Bankruptcy Code of India 2016**

The Insolvency and Bankruptcy Code 2016 (IBC 2016) is a major regulatory reform that outlines a consolidated corporate insolvency procedure in India. Before enactment of the IBC 2016, there were overlapping legislation (e.g. the Companies Act 2013, the Sick

Industrial Companies Act 1985, and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002), and adjudicating authorities in the country dealing in financial failures and insolvency resolutions of corporate persons, partnership firms and individuals. The IBC 2016 offers a clear time-bound speedy process to identify financial distress at an early stage and to initiate revival procedures (if viable), plus a mechanism for collective insolvency procedures. The IBC 2016 sets strict time bounds for the reorganization of financially distressed companies or application for bankruptcy (resolutions to be completed within 180 days, which can be extended by 90 days in special cases). It aims to maximize the value of assets of corporate persons, partnership firms and individuals during insolvency and bankruptcy proceedings, to promote entrepreneurship, availability of credits, and to balance the interests of all stakeholders. The Code set out to establish ‘the Insolvency and Bankruptcy Board of India’ as an insolvency regulator to oversee insolvency proceedings in the country. According to the Code, corporate insolvency proceedings are to be managed by licensed insolvency professionals who will be educated by insolvency professional agencies. Two separate tribunals are proposed to adjudicate insolvency resolutions, i.e. the National Company Law Tribunal for companies, and the Limited Liability Partnership Firms and Debt Recovery Tribunal for individuals and other partnership firms<sup>10</sup>.

The IBC 2016 intends to protect the interests of both secured and unsecured creditors by offering a procedure for collective insolvency rather than merely a debt recovery mechanism. The Code simplifies the insolvency and bankruptcy procedures and acts as the external control mechanisms of CG by protecting the interests of small investors.

The evolution of Indian CG has completed important legislative reform phases taking more than two decades. Having strong CG provisions in the Companies Act and several mandatory code provisions in the Equity Listing Agreement, the regulators intended to align Indian CG with global standards as well as to embed country-specific characteristics.

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<sup>10</sup> See Insolvency and Bankruptcy Code, 2016. Available at <https://ibbi.gov.in/webadmin/pdf/legalframework/2017/Jul/IBC%202016.pdf>. (Accessed 6 August 2019).

### **3.5. Corporate governance systems in the USA, UK and India: a comparison**

The national stock exchanges, the domestic professional associations, and the governments, because of the strong pressures of external forces, may be forced to change CG practices in the country, not only to increase the efficiency of domestic companies, but also to harmonize the national CG system with international best practices (most often the US and UK CG practices are taken as the international best practices) (Zattoni and Cuomo, 2008), resulting isomorphism across countries, at least in the adoption of some governance practices (Guler et al., 2002). However, differences in economic conditions and institutional influences may influence agency costs arising from different ownership structures (Jensen, 1983). Hence, some of the CG issues relevant to companies in the US or the UK may not be significant for companies listed in other countries (Craswell et al., 1997), such as in India.

In many aspects, Indian CG is much closer to the CG framework of the United Kingdom than to that of the United States of America, because of two centuries of British colonial rule (Narayanswamy, 1996). However, there are some fundamental differences in the CG environment among these three countries.

#### **i. Regulatory framework**

The traditions of formulating laws and regulations for companies and stock exchanges differ among the USA, UK and India. In the USA, each state's government formulates its own Companies Acts, but the federal government enacted the Sarbanes-Oxley Act 2002, which oversees and regulates auditing of US companies, and provides guidelines for financial reporting, internal control, and CG (Rishi and Singh, 2011; Coates and Srinivasan, 2014). In the United Kingdom, the central government issues and amends the Companies Acts as a comprehensive code, such as the Companies Act 2006 (first issued in 1856). Other codes are developed by independent authorities, such as the Turnbull Combined

Code 2014 (first published in 1999), which has been periodically amended and administered by the Financial Reporting Council (FRC). In India, the legal framework for the registration, functioning and winding up, and CG of the companies are broadly covered in the Companies Act 2013 passed by the Central Government and regulations issued by the SEBI in Clause 49 of the Listing Agreement.

The vital difference in legal frameworks among these three countries can be found in the enforcement of laws. In the USA, CG codes have developed as a hard law, i.e. ‘comply or die’, in the form of Sarbanes-Oxley Act 2002 (Aguilera and Cuervo-Cazurra, 2009; Rishi and Singh, 2011). The UK adopts soft law for CG based on a ‘comply or explain’ approach, such as the Combined Code of Corporate Governance issued by the Financial Reporting Council (Aguilera and Cuervo-Cazurra, 2009). The UK CG codes are voluntary and have no strong judicial enforcement, but the London Stock Exchange can enforce possible sanctions for non-compliance (Ow-Yong and Guan, 2000). In India, CG codes and regulations continue to be developed and revised. India adopts a mixed approach to CG, having both mandatory and voluntary governance codes. As an independent regulator of the stock exchanges, the Securities and Exchange Board of India (SEBI) has classified CG codes as mandatory and non-mandatory codes to be complied with or explained by the companies. Recently code provisions have been incorporated in the Companies Act 2013.

Similarly, there are significant differences in the litigation environments of the USA, UK, and India. The US Government provides support with litigation tools for shareholders to sue companies or their managers, or for plaintiff lawyers to use on behalf of shareholders in class actions (Coates and Srinivasan, 2014). Unlike in the USA, the UK government has not yet introduced class action litigation in its legal framework, so the shareholders and creditors have to rely on other legal, regulatory, and informal devices. In India too, there was no such litigation environment before the enactment of the Companies Act 2013. The Government has recently introduced class action litigation to the members or depositors of companies against the company or its directors or auditor or audit firm or its expert/advisor/consultant/any other person for any fraudulent, unlawful or wrongful act or

omission or conduct or any likely acts in the Companies Act 2013 (Section 245). This provision is still new, and many hurdles may come in its implementation since there are no plaintiff's law firms, little incentive for law firms to represent the cases, prohibitive costs of filing cases, and delays within the legal system. Unlike in the USA and the UK, the legal framework for insolvency and liquidation proceedings in India is not efficient and creditor-friendly (Narayanswamy et al., 2012). Recently, the new Companies Act 2013 and Insolvency and Bankruptcy Code 2016 have made several refreshing provisions to deal with bankruptcy and liquidation issues, but it is too early to make a fair assessment of these act's impacts on the CG in India.

With the rise of globalization, the regulatory framework in India has been comprehensively and rigorously reformed. New and advanced codes and regulations have been developed from the government and independent professional bodies. Although India's accounting, auditing and governance standards have been harmonized with international standards (Narayanswamy et al., 2012), because of social and cultural disparities, significant divergences still exist in practices. The enforcement and implementation of laws and regulations have remained challenging, particularly about the role of nominee directors from financial institutions, stock listing laws and regulations, insider trading, and dividend and share transfer transactions (The World Bank, 2004). However, recently, the Government of India enacted the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 to strengthen the enforcement of laws in protecting minority investors, enforcing contracts and resolving insolvency. These regulatory reforms have significant impacts on India's position in the World Bank's global rankings for ease in doing business<sup>11</sup>. The World Bank's Doing Business Reports 2018<sup>12</sup>

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<sup>11</sup> The World Bank Group's Doing Business ranks India in 77<sup>th</sup> position among 190 countries for ease in doing business in 2019 compared with 100<sup>th</sup>, 130<sup>th</sup>, and 134<sup>nd</sup> in 2018, 2017 and 2014, respectively.

<sup>12</sup> See "A World Bank Group's Flagship Report: Doing Business 2018", available at [www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf](http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf) (Accessed 1 May 2019).

and 2019<sup>13</sup> show India among the top ten countries in the world to have remarkable improvements in regulatory reforms.

## **ii. Board structure and committees**

A clear distinction exists between the USA, the UK and India in board leadership structure, composition, types of directors, and board regulations of companies.

### **- Board leadership structure**

There is an ongoing debate about board leadership structure, i.e. “whether the firm’s CEO should serve simultaneously as the chairperson of the board or whether these roles should be separately held” (Dalton and Dalton, 2011: 405). There is no law or CG code for the US listed companies to have separate individuals for CEO and chairman roles. Hence, CEO duality is common in the US companies, for example, Rhoades et al. (2001) show above 75 per cent and Thomas (2004) and Aguilera et al. (2006) report 80 per cent of the U.S. companies have CEOs with a dual role. Krause et al. (2014) find it 60 per cent (down from 80 per cent) in S&P 500 firms after the enactment of the Sarbanes-Oxley Act 2002. In the UK, the Cadbury Committee Report 1992 and UK Corporate Governance Codes recommend for the separation of CEO and chairman role, which is supported by the London Stock Exchange Group (2011). Any non-compliance with this code must be justified. In India, before the issuance of MCA’s Corporate Governance Voluntary Guidelines 2009, there was no such provision for duality or separation of CEO and chairman roles in the board leadership structure. The CG Voluntary Guidelines 2009 made a definite recommendation for demarcation of the roles and responsibilities of the CEO and chairman of companies, to promote the balance of power. Also, the Companies Act 2013 has recently made it a mandatory provision for a company to separate CEO and chairman

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<sup>13</sup> See “A World Bank Group’s Flagship Report: Doing Business 2019”, available at [www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report\\_web-version.pdf](http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf) (Accessed 1 May 2019).

roles unless: a) the Articles of Association provides otherwise; or b) the company does not carry on multiple businesses.

**- Composition of the board of directors**

In the USA, there is no uniformity in the legal/regulatory requirements for the types of the board of directors. Stock Exchanges like NYSE, and NASDAQ's Listed Company Manuals classify the directors of the companies into two types, dependent and independent. Similarly, in the UK too, the Companies Act 2006 and UK Corporate Governance Codes classify the directors of the companies into two types, executive and non-executive (in particular, independent non-executive directors). In contrast, in India, the Companies Act 2013, Clause 49 of the LA (revised in 2004, and 2014), and the Voluntary Guidelines 2009 classify company directors into three types, executive, non-executive, and independent.

In the USA, NYSE and NASDAQ's Listed Company Manuals require listed companies to have a board of directors with a majority of independent directors. There is no fixed limit for the number of directors on the board of a US company. In the UK, the Companies Act 2006 requires a company to have at least two directors on the board, but the maximum number of directors is not restricted. The London Stock Exchange Group (2011) does not believe in limiting the number of non-executive directors. The UK Corporate Governance Code requires the boards of large companies to comprise at least one-half, excluding the chairman, independent non-executive directors, whereas small companies are required to have at least two independent non-executive directors. The legal provision for the composition of a board of directors in Indian companies is different from that of the USA and the UK. The Companies Act 2013 set the limit of 3 to 15 directors for listed companies, with at least one woman director. The board needs to comprise a minimum of 50 per cent non-executive directors. A company, with the non-executive chairman, should have at least one-third independent directors; and without a non-executive chairman or non-executive chairman from the promoter, it should have at least 50 per cent independent directors.

A full-time executive director, as required by the UK Corporate Governance Codes, cannot take more than one non-executive directorship or chairmanship in FTSE 100 companies. The annual election of all directors should be held in FTSE 350 companies and every three years in other companies. Non-executive directors' tenure is limited to six years, and any term beyond six years should be subject to rigorous review. Any non-executive directors after nine years tenure should be re-elected annually. In India, a person can take total directorships in twenty companies (all types) including maximum ten directorships in listed companies (the Companies Act 2013), but as per the Clause 49 of the Listing Agreement a person can take independent directorships of maximum seven listed companies. The CG Voluntary Guidelines 2009 allows a managing director or whole-time director to serve as a non-executive or independent director in maximum seven companies but Clause 49 of the Listing Agreement has set this limit to three listed companies. The CG Voluntary Guidelines 2009 and the Companies Act 2013 have fixed a maximum tenure of six years (plus three years cooling period) for non-executive directors. Clause 49 has set a maximum tenure of five years (plus three years cooling period) for an independent director.

In the UK, the minimum age limit for a person to be appointed as the company director is 16, but there is no maximum age limit for that position. However, in India, the Companies Act 2013 has set the age limit of directors as 21-70 years. Interestingly, in India, any individual intending to be appointed as a director in a company needs to apply to the Central Government for a Director Identification Number (DIN). No person shall be appointed as a director of a company without a DIN and contravention of this provision is subject to punishment of up to six months' jail sentence or up to the fine of INR 50,000. The DIN is a unique provision in India, not seen in the USA and the UK.

- **Committees of board members**

- **Nomination and Remuneration Committee**

A US listed company is required to have separate Nominating/Corporate Governance and Compensation committees consisting of all independent directors. However, in India, a

company should have a single committee of directors that performs both the roles of nomination and remuneration and does not require all the members of the committee to be independent directors. The Companies Act 2013 requires a listed company to form a Nomination and Remuneration Committee consisting of three or more non-executive directors at least one-half of whom shall be independent. Before this provision, the Voluntary Guidelines 2009 required companies to have a Remuneration Committee comprising three members of whom a majority should be non-executive directors with at least one an independent director.

- **Audit Committee**

In the USA, the Securities Exchange Act 1934, the Blue Ribbon Committee Report 1999, the Independence Standard Board 1997, and the Sarbanes-Oxley Act 2002 have made it mandatory for all listed companies to have Audit Committees of at least three directors, all independent. Each member of an Audit Committee should be financially literate, with at least one member expert in accounting and financial management. In the UK, the Cadbury Report 1992 and UK CG Codes require companies to have Audit Committees of at least three, or in the case of smaller companies, two independent non-executive directors, with at least one member having recent and relevant financial expertise. In India, the Voluntary Guidelines 2009, the Companies Act 2013, and Clause 49 of the Listing Agreement require listed companies to have Audit Committees of at least three directors with majority independent directors under the Chairmanship of an independent director. There is a clear divergence among these countries in the requirement for Audit Committee independence: the USA and the UK require all independent directors in the Audit Committee, but in India, only a majority should be independent.

There is no agreement in regulatory provision for the qualification of Audit Committee members in India. The Companies Act 2013 and Clause 49 require the majority members of Audit Committee including the Chairperson to be financially literate whereas the

Voluntary Guidelines 2009 requires all members of Audit Committee to have knowledge of financial management, accounting and auditing.

### **iii. Ownership structure**

#### **- Ownership: dispersed or concentrated**

Ownership structure, which plays a significant role in shaping CG mechanisms of companies, is another area of divergence among US, UK and Indian companies. In the USA as well as in the UK, corporate ownership is widely dispersed among small shareholders (LaPorta et al., 1999; Aguilera et al., 2006) with no controlling shareholders and no pyramidal structure (Enriques and Volpin, 2007). The concentration of voting power is modest. The principal agency problem is between managers, and the dispersed and insufficiently interventionist shareholders of companies (Becht and Röell, 1999). In India, the corporate sector is dominated by family-run businesses where ownership is concentrated within family groups. Even though the Indian Companies Act and Clause 49 of the Listing Agreement require companies to treat all shareholders (minority, institutional and foreign) equitably, firms are in complete control of the promoters and family members. There exists unfair treatment between minority and majority shareholders (Rishi and Singh, 2011) that results from a unique agency problem stemmed from the principal-principal goal incongruence (Dharwadkar et al., 2000; Douma et al., 2006; Young et al., 2008).

#### **- Types of ownership: family, institutional and foreign owners**

Corporations in the USA and UK have a substantial presence of institutional investors, which leads to shareholder activism in companies. In the USA, investment companies (mutual funds) and investment advisors (money management funds) are the largest institutional investors, whereas in the UK insurance companies and pension funds are the major institutional investors (Aguilera et al., 2006). Institutional investors are rather vigilant and strict in reprimanding any non-adherence of CG norms that result in better compliance and performance (Rishi and Singh, 2011). The UK has no restriction for

individuals, institutions, and foreigners on the ownership of companies. Foreign investors own a majority ownership shares in UK companies, i.e. 53.2 per cent in 2012 compared with 30.7 per cent in 1998 (ONS, 2014).

In India, the pattern of company ownership is significantly different from the USA and UK. There were very few companies (less than 2 per cent in 2003) under widely held ownership, and no significant single-promoter controlled companies (Chakrabarti et al., 2008). Institutional investors are not available to all the companies as they choose only the companies with higher productivity potentials (Lodh et al., 2014), and their roles are rather irresponsible and not assisting in strengthening CG in India (Rishi and Singh, 2011). Among the largest 500 Indian companies, 60 per cent of companies, making up 65 per cent of the total market capitalization, were family firms, whereas 11 per cent of companies, making up 22 per cent of the total market capitalization, were government-owned (Chakrabarti et al., 2008; Jackling and Johl, 2009). Family-owned firms are mainly associated with diversified business groups (Khanna and Palepu, 1997; Ghemawat and Khanna, 1998; Cuervo-Cazurra, 2006), usually in pyramidal form (Khanna, 2000), comprised of a diverse set of firms, often initiated by a single family, and bound together by equity cross-ownership and common board membership (Fisman and Khanna, 2004). Family-owned firms present exceptional situations where in the interests of the organizations get dominated by the interests of family groups (Rishi and Singh, 2011).

Foreign institutional investors are allowed to have a majority stake in Indian companies, and they are required to register with the SEBI and Reserve Bank of India (Poshakwale, 2002), and even FIIs/NRIs/PIOs can hold 100 per cent paid-up capital in some companies under Portfolio Investment Scheme (PIS) (Reserve Bank of India, 2014). According to the Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry, the total cumulative amount of FDI inflows from April 2000 to August 2014 was US\$ 341,357 million, which was US\$ 17,445 million in the five months from April 2014 to August 2014. “Foreign investors, often being minority shareholders, are concerned about how well their interests are protected from expropriation by controlling shareholders and

managers” (Poshakwale and Thapa, 2011: 117). In this regard, according to the World Bank’s Doing Business Report 2019, India ranks in a better position (7th in the world) for the protection of minority investors compared to the UK (15th) and the USA (50<sup>th</sup>)<sup>14</sup>.

Another interesting divergence of companies’ ownership type in India from that of the USA and UK is the prevalence of publicly-traded state-owned companies (SOEs). The USA has 17 federal government corporations, and the UK has 20 state-owned corporations which are wholly owned by taxpayers, and none of these is publicly traded. However, in India, there are many publicly traded companies, either wholly-owned or majority-owned by state or central government. In 2006 there were 1,618 government-owned corporations (OECD, 2009) and in the same period, six Indian companies were on the list of Fortune 500 companies, of which five companies were SOEs (Chakrabarti et al., 2008). The dominance of SOEs has significant impacts on policy formulation and markets for corporate control.

#### **iv. Stakeholder relationship**

In the USA and UK, stakeholders, such as employees, creditors, and minority investors, are well protected by the law. India too has the strong legal protection of investors as it has English common-law origin and British-style judicial system, and democratic government, but, in practice, actual protection is weak owing to the inefficiency of legal institutions and corruption (Allen et al., 2012). Filatotchev et al. (2011) argue that the CG in emerging countries is ineffective in improving corporate transparency and mitigating widespread information abuses, such as informal flows of information between well-connected investors and managers of firms in their portfolios, managerial dealings on insider information or information manipulation, and, so forth. India is also not an exception. According to Pattnaik et al. (2013), a majority of her companies are family-controlled and business group-affiliated, and they are often reluctant to disclose information to market

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<sup>14</sup> See “A World Bank Group’s Flagship Report: Doing Business 2019” (Online). Available at [www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report\\_web-version.pdf](http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf). (Accessed 1 May 2019).

participants or outside constituents/stakeholders. In such companies, the stakeholders are mostly deprived of getting and unbiased information.

In Indian government and public-sector companies, the information rights of their stakeholders are protected by the Right to Information Act 2005 similar to the US Freedom of Information Act 1974 and the UK Freedom of Information Act 2000 (Roberts, 2010). However, the Act does not cover the whole corporate sector.

#### **v. Financial accounting, auditing and reporting**

Accounting and auditing are vital components of CG mechanisms, so Governments and independent professional organizations aim to improve financial accounting and reporting standards. In India, the Government directly influences accounting and auditing process, via the Companies Acts and other regulations, having the provisions of comprehensive accounting and auditing requirements, applicable to all companies. In this case, the Indian practice can be analogized to the SOX 2002 in the USA. However, in the UK, the securities markets and the securities legislations have a dominant influence on accounting and auditing practice.

A notable divergence can be found in accounting and auditing standards-setting processes among the USA, UK, and India. In the USA and UK, accounting and auditing standards are set by private and independent regulators, i.e. the Financial Accounting Standards Boards (FASB) in the USA and the Financial Reporting Council (FRC) in the UK. In India, the Government sets and issues the accounting and auditing standards after taking suggestions from a committee that includes representatives of professional bodies, industry associations, the securities regulator, the Reserve Bank of India, and the Comptroller and Auditor General of India (Narayanswamy et al., 2012) (Also see Appendix 3.A). The Indian Companies Act requires companies' accounts to be audited only by Chartered Accountants registered in India or by members of ICAI. It restricts 'The Big 4' international audit companies (DTT, PWC, KPMG, and EY), from direct involvement in auditing of the Indian companies. Instead, they provide audit service via their Indian

affiliates. The USA and UK have no such type of restriction for auditing practices. Further, it is believed that the Big 4 auditors provide higher quality audits and more straightforward due diligence process but higher auditing costs (O'Sullivan, 2000; Khurana and Raman, 2004; De Franco et al., 2011). In practice, compared to the companies of developed and some of the developing countries, Indian listed companies are not so attracted to the four big-name auditors and their affiliates (Narayanswamy et al., 2012).

Jurisdictions in the USA and UK limit the length of audit partners (individual auditors), who are subject to mandatory rotation every five years; but the jurisdictions of these countries are silent about the rotation of the audit firms (Lennox et al., 2014). In contrast, Indian jurisdictions require both audit partners and audit firms to be rotated, to ensure auditors' independence. Companies can appoint or reappoint an individual as an audit partner for a maximum term of five years and an audit firm for two terms of five consecutive years. Having completed those terms, they are not eligible for reappointment as an auditor in the same company for the next five years. Notwithstanding such jurisdictions' requirements for auditors' independence, most companies are reluctant to change their auditors and audit firms. "In many cases, Indian audit firms have long associations with the founding families, and the relationship between them is often as much personal as professional. In some cases, the auditors and the clients even share common family roots. Hence, the founders and their descendants avoid changing auditors in order not to offend the long-serving auditors and jeopardize other social relationships" (Narayanswamy et al., 2012: pp. 596).

Similarly, a significant difference can be found in financial and business reporting responsibility among these three countries. In the USA, the management of a company is responsible for the certification of the financial report. According to Section 302 of the Sarbanes Oxley Act 2002, "the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted." The signing officers are responsible for establishing and maintaining internal controls of the companies. In contrast, in the UK, the Corporate

Governance Code has made the Board of Directors of the companies fully responsible for preparing the accounts and annual reports in a fair, balanced and understandable form.

In India, both the Board of Directors and management are responsible for preparing, certifying and reporting of financial statements and disclosure of firm-specific information to outsiders. According to Section 134 of the Companies Act 2013, “the financial statements shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company where he is authorized by the Board or by two directors out of which one shall be managing director and the CEO, if he is a director in the company, the CFO and the company secretary of the company, wherever they are appointed.”

#### **vi. Markets for finance**

A notable divergence can be found in financial systems, i.e. the supply-side of capital, among the USA, UK, and India. The USA and UK have market-based financial systems that encourage equity financing through active capital markets in which shareholders invest mainly to attain their financial interests and hold control over the firm (Aguilera and Jackson, 2003). These markets are equity-focused and monitored by disclosure rules and the market for corporate control (Khanna and Palepu, 1997 and 2000). Inter-firm networks of capital ties (ownership and credit), also known as network multiplexity that reinforces strong tie-up among firms and the commitment of capital by making an exit costlier, is weaker or non-existent (Aguilera and Jackson, 2003).

India has witnessed some remarkable development of capital markets. The Indian stock market is rapidly growing. The country has three stock exchanges: the Bombay Stock Exchange (BSE) is the largest stock exchange in the world in terms of number of companies listed and Asia's first stock exchange, established in 1875; the National Stock Exchange (NSE), established in 1992; and the MCX Stock Exchange (MCX-SX), established in 2013. Notwithstanding fast-growing stock markets, there are very few Indian companies with widely held ownership; shareholdings remain rather concentrated with

promoters, family groups, and state enterprises (Chakrabarti et al., 2008). In such circumstances, capital requirements are fulfilled from their internal markets of capital among affiliated firms of the same business group. In the USA and UK, banks and legal institutions have generally been viewed as facilitating the roles of markets, providing funds for corporate sectors, and allocating resources in the economy (Allen et al., 2012). However, in India, family control and group affiliation are resulting in poor disclosure practices and information asymmetry between the internal and external constituents. As a result, the external capital markets are not efficient, investors' confidence is low, and financing/transactions costs are very high (Pattnaik et al., 2013). The formal financial markets and associated legal institutions have played limited roles and firms mostly have been relying on illegal mechanisms/alternative financial channels including trade credits and finance from friends and family (Allen et al., 2012).

### **3.6. Discussion and conclusion**

CG reform in India is the deliberate outcome of the country's economic liberalization since 1991 which amid pressurized for institutional changes. During its economic transformation process, the country witnessed several financial scandals and crimes in its corporate sector, which caused financial and capital market crashes. These events created challenges of transparency and trusts among firms, regulators, investors, and the general public. Similarly, India opened its markets for foreign institutional investors and Indian companies started to enter into the global markets. Countries with weak shareholder protection, high government liberalization, and a strong presence of foreign institutional investors tend to have prompt CG reforms because of legitimization pressures and efficiency needs (Aguilera and Cuervo-Cazurra, 2004). As a consequence, the government authorities and industry-led professional bodies have urgently tried to bring changes in the CG system of the Indian companies. The global move towards strong CG measures and codes of best practices also became guidelines to the Indian Government, regulatory bodies, private sectors and professionals to accelerate the changes in CG landscape in the country. The CII, SEBI and MCA have contributed to the process by forming several committees to

constitute CG regulations and guidelines. During this process the CII brought 'The Desirable Corporate Governance: A Code' in 1998; the SEBI brought 'Clause 49 of the Listing Agreement' in 2000; and the MCA amended the Companies Act, introduced 'Corporate Governance Voluntary Guidelines 2009', and formed 'National Foundation for Corporate Governance'. Hence, according to the institutional theory perspective, these developments indicate the convergence of Indian CG systems with the international best practices by diffusion of good CG codes.

The institutes for CG systems in India are determined following path dependence, i.e. a situation where the current state of a system is determined not only by its initial conditions but also by the path it took (North, 1990; 2005). The evolutionary trajectory of the governance system of a country is the result of several individual historical events and policy responses to them (Yoshikawa and Rasheed, 2009). For example, the legal framework for CG in India is primarily inherited from the English Common Law traditions, but with the increasing globalization of the Indian economy, the country's CG provisions are now aligned more closely with the international standards and practices. More severe sanctions have been introduced for the violation of CG rules years after the substantive laws were enacted (Dharmapala and Khanna, 2013). Indian legal requirements in some areas like board structure, disclosure, board procedure, and related party transactions are sufficiently strict, and over-compliance of such provisions are costlier and not producing any valuable gains to the companies (Narayanswamy et al., 2012). Notwithstanding the strong legal provisions for CG from the regulatory authorities, the repetition of financial scandals and dishonest corporate behaviour help to cast some doubt on effective enforcement and monitoring of CG rules developed over the period. As argued by Balasubramanian et al. (2010), the Government enforcement actions against firms for non-compliance of CG rules are almost nonexistent.

Compared to the CG provisions of the USA and UK, the Indian CG framework is different. In the USA, CG rules have been issued as hard laws, such as the Sarbanes-Oxley Act 2002. It provides regulatory outputs ensuring all companies implement high minimum standards

but at the cost of the lack of flexibility regarding the characteristics of companies, i.e. based on a 'Comply or Die' approach. In the UK, CG rules have been issued as soft law which is characterized by the prominence of standardized reporting based on a 'Comply or Explain' approach (Aguilera et al., 2013). Whereas in India, initially CG rules were developed as soft law tilting to the UK 'Comply or Explain' approach but after the amendment of the Companies Act in 2013 several CG provisions have been incorporated in the Act as the hard laws. This regulatory shift entails a trade-off between flexibility and enforceability that results in higher degrees of enforcement but restricts listed companies to mix different practices of CG in diverse organisational environments in India. However, the findings show that Indian CG systems neither fully converge to, nor completely diverge from, the Anglo-American model. Rather, Indian system selectively adopts features from the US and UK models, decouple them from the original context, and tailor them to fit their local contexts to gain legitimacy and achieve efficiency in firm level.

India has a unique corporate environment. For example, a significant number of companies owned by central and state government in India are trading publicly, which is rare in the USA and UK. Governments are less likely to use their influence to maximize company profits but rather to maximize employment, even hiring additional workers who could not justify a firm-level cost-benefit analysis (Megginson, 2005). Hence state owners could be reluctant to allow CG improvements and strict enforcement of CG laws/codes. Similarly, ownership of most companies is concentrated on affiliated families. The external capital market is not so developed, whereas in the USA and UK, ownership is widely dispersed, and the external capital market is competitive and well developed. Family-controlled firms can have poor stakeholder relationships as they tend to have poor corporate transparency, with information abuses to their stakeholders. In family-controlled firms, both business- and family-centred goals coexist. Family owners often undermine the essence of good CG and firms' economic value maximization; hence, a secondary form of CG problem exists - specifically conflicts between controlling shareholders and minority shareholders (principal-principal conflicts) (Young et al., 2008; Jiang and Peng, 2011; Daspit et al., 2018).

In contrast to the US and UK practices, the Indian Government is directly involved in setting and issuing accounting and auditing standards. This practice involves government employees in the setting and enforcement of accounting and auditing standards, which exert a strong political influence on accounting and auditing at the national and firm-level (Ball et al., 2000). International accounting and auditing firms are not allowed to audit companies in India so that national and regional accounting firms largely control the Indian corporate audit market. In terms of board leadership, board composition, types of directors, directors' licence or ID number, India has made unique provisions. Similarly, requirements for Audit and Remuneration Committees' independence, qualification and expertise are different for Indian companies. These unique features of Indian CG systems are embedded from contextual factors (Aguilera et al., 2008), grounded in the diverse institutional environments in India exerting direct impacts on boards' behaviour and quality of CG.

This paper describes a coherent evolution of CG in a vibrant emerging economy, India. Its policymakers, regulators, and professional bodies are heavily engaged in this reform process. Since all the provisions for CG mechanisms have been amended and incorporated in the form of Codes of Practice, Voluntary Guidelines, Equity Listing Agreements and the Companies Acts, now it is time to assess the outcome of the reform, using the post-reform data of listed companies. Further empirical studies are warranted to assess the effectiveness of CG and examine whether such governance reforms provide any impact on firm performance. Further empirical studies are desirable to evaluate the firm-level performance effects of CG systems and to look at more countries, both emerging and advanced.

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### Appendix 3.A: Comparative corporate governance in the USA, UK and India

| Areas                            | United States                                                                                                                                                                                                                                                                                                                                       | United Kingdom                                                                                                                                                                                                                                                                                                              | India                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|----------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Sources of Codes                 | States, e.g. Delaware General Corporation Law (DGCL), and Federal, e.g. Securities Act 1933, Securities Exchange Act 1934, Sarbanes-Oxley Act 2002, Dodd-Frank Act 2010. The Securities Exchange Commission (SEC) and NYSE, NASDAQ act as ongoing rule-makers for listed companies                                                                  | Central government law; Joint Stock Companies Act 1856 (with periodic amendments, latest the Companies Act 2006), Cadbury Committee Report 1992, Hampel Report 1998, The Combined Corporate Governance Code                                                                                                                 | Central government law, Companies Act of 1866 (as amended, latest in 2013), Corporate Governance Voluntary Guidelines 2009, Clause 49 of the Listing Agreement (2000 and amended)                                                                                                                                                                                                                                                                                                          |
| Regulation of stock exchange     | Securities and Exchange Commission, since 1934                                                                                                                                                                                                                                                                                                      | Financial Conduct Authority (FCA) (Listing Rules from 2005) and London Stock Exchange (self regulated)                                                                                                                                                                                                                      | Ministry of Finance up to 1988, now Ministry of Corporate Affairs (MCA) and Securities and Exchange Board of India (SEBI) since 1992. Developing more independent regulation/codes                                                                                                                                                                                                                                                                                                         |
| Corporate Governance Codes       | <ul style="list-style-type: none"> <li>• First country to issue the code of good governance in 1978. Since then the SEC, the NYSE, and the Business Roundtable have been issuing the codes</li> <li>• Developed hard law in the form of the Sarbanes-Oxley Act 2002</li> <li>• By 2008, the USA has created and issued 25 distinct codes</li> </ul> | <ul style="list-style-type: none"> <li>• ‘The Cadbury Committee Report 1992, the flagship guideline of the UK corporate governance, which triggered the development of codes worldwide</li> <li>• By 2008, the UK has also created 25 distinct codes</li> <li>• UK adopts soft law, such as the UK Combined Code</li> </ul> | <ul style="list-style-type: none"> <li>• Corporate governance codes first issued by Confederation of Indian Industry (CII) in 1998 and another by SEBI in 2000</li> <li>• SEBI reviewed its codes in 2004, 2006 &amp; 2014, particularly for the role of board of directors), and to align with Companies Act</li> <li>• MCA issued Corporate Governance Voluntary Guidelines 2009 requiring companies to publish a code of conduct for all board members and senior management</li> </ul> |
| Board leadership structure (CEO) | <ul style="list-style-type: none"> <li>• There is no listing rule that mandates separate individuals for CEO and board chairman</li> </ul>                                                                                                                                                                                                          | <ul style="list-style-type: none"> <li>• Splitting roles of CEO and Chairman of Board recommended by Cadbury Committee Report</li> </ul>                                                                                                                                                                                    | <ul style="list-style-type: none"> <li>• First time in India, the Corporate Governance Voluntary Guidelines 2009 (A.2.) recommends clear demarcation of</li> </ul>                                                                                                                                                                                                                                                                                                                         |

|                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| duality or non-duality)           | roles. Corporate boards decide leadership structure of board and company, but SEC requires reporting company to disclose board's leadership structure and why it is best                                                                                                                                                                                                                                                                                                                                                                                                                   | 1992 and UK Corporate Governance Code 2012 (Code Provision A.2.1)<br><ul style="list-style-type: none"> <li>London Stock Exchange Group (2011) strongly supports a clear division in functions and duties of CEO and Chairman. if not done, it must be justified</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | roles and responsibilities of CEO and Chairman as far as possible, to promote balance of power<br><ul style="list-style-type: none"> <li>The Companies Act 2013 provides that "companies shall not appoint or reappoint an individual as the chairperson, as well as the managing director or CEO of the company at the same time unless: a) the articles of such a company provides otherwise; or b) the company does not carry multiple businesses" (Ch. XIII: 203(1))</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| Composition of board of directors | <ul style="list-style-type: none"> <li>No uniform regulation in the country for the composition of board of directors. Different states and Stock Exchanges have their own regulations</li> <li>The New York Stock Exchange (NYSE) Listing Manual requires that listed companies must have: <ul style="list-style-type: none"> <li>A majority of independent directors in the Board of Directors</li> <li>A nominating/corporate governance committee composed of all independent directors</li> <li>A compensation committee composed of all independent directors</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>UK Companies Act 2006 requires: <ul style="list-style-type: none"> <li>A public limited company should have at least 2 directors</li> </ul> </li> <li>The UK Corporate Governance Code 2014, (B.1.2) requires: <ul style="list-style-type: none"> <li>In large companies – at least half the board, excluding the chairman, should comprise independent non-executive directors. In small companies – at least 2 independent non-executive directors</li> <li>A full-time executive director cannot take more than one non-executive directorship or chairmanship in FTSE100 companies (B.3.3)</li> <li>Annual election of all directors in FTSE350 companies and for other companies, interval for re-election is 3 years (B.7.1)</li> <li>Non-executive directors'</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>Indian Companies Act 2013 requires: <ul style="list-style-type: none"> <li>A public limited company should have 3 - 15 directors with at least one woman director</li> </ul> </li> <li>Clause 49 of the LA of SEBI requires: <ul style="list-style-type: none"> <li>The Board needs to comprise not less than fifty per cent non-executive directors</li> <li>Provision of independent directors: company with non-executive Chairman – at least one-third (33.33%) directors; company without non-executive Chairman or non-executive Chairman from promoter – at least one-half (50%) directors should be independent</li> <li>Total directorship a person can take is 20; the maximum public companies a person can be appointed as director is limited to 10 (The Companies Act 2013). But as per Clause 49 of the LA, the independent directorship for a person is limited to 7 listed companies</li> <li>A Managing Director or Whole-time Director can serve as a non-executive or</li> </ul> </li> </ul> |

|                                         |                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|-----------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                         |                                                                                                                                                                                                                                                     | <p>maximum tenure is 6 years. Beyond that, subject to rigorous review, and after 9 years to annual re-election</p> <ul style="list-style-type: none"> <li>• LSE Group (2011) doesn't believe in limiting the number of non-executive directors</li> </ul>                      | <p>independent director in maximum 7 companies (CG Voluntary Guidelines 2009) but the Clause 49 limits to 3 listed companies</p> <ul style="list-style-type: none"> <li>- Non-executive directors' maximum tenure is 6 years (plus 3 years' cooling period) (CG Voluntary Guidelines 2009; the Companies Act 2013). But the Clause 49 has set the maximum tenure of an independent director 5 years term plus 3 years cooling period</li> </ul> |
| Types of directors                      | <ul style="list-style-type: none"> <li>• Two: independent and non-independent</li> </ul>                                                                                                                                                            | <ul style="list-style-type: none"> <li>• Two: executive and non-executive (independent non-executive)</li> </ul>                                                                                                                                                               | <ul style="list-style-type: none"> <li>• Three: executive, non-executive, and independent</li> </ul>                                                                                                                                                                                                                                                                                                                                            |
| Board size                              | <ul style="list-style-type: none"> <li>• Minimum of one director, who must be a natural person</li> </ul>                                                                                                                                           | <ul style="list-style-type: none"> <li>• At least 2 directors, but, no upper limit of directors</li> </ul>                                                                                                                                                                     | <ul style="list-style-type: none"> <li>• Minimum 3, maximum of 15 directors for a public limited company</li> </ul>                                                                                                                                                                                                                                                                                                                             |
| Directors' licence/Id Number            | <ul style="list-style-type: none"> <li>• Not required</li> </ul>                                                                                                                                                                                    | <ul style="list-style-type: none"> <li>• Not required</li> </ul>                                                                                                                                                                                                               | <ul style="list-style-type: none"> <li>• Every individual intending to be appointed as director of a company shall obtain Director Identification Number</li> </ul>                                                                                                                                                                                                                                                                             |
| Ownership: dispersed or concentrated    | <ul style="list-style-type: none"> <li>• Widely held or dispersed among small shareholders, no pyramidal ownership</li> <li>• The main agency problem is between managers and dispersed, and insufficiently interventionist shareholders</li> </ul> | <ul style="list-style-type: none"> <li>• Widely held but less dispersed than in USA</li> <li>• No controlling shareholders and pyramidal ownership, concentration of voting power is very modest</li> <li>• The agency problem is between shareholders and managers</li> </ul> | <ul style="list-style-type: none"> <li>• Concentrated with family groups, family-run businesses dominate the ownership structure</li> <li>• Equitable treatment of all shareholders including minority, institutional &amp; foreign, required</li> <li>• Firms' promoters are in complete control and minority can be treated unfairly. Agency problem between controlling and minority principals</li> </ul>                                   |
| Ownership of the companies: Individual, | <ul style="list-style-type: none"> <li>• Substantial presence of institutional investors, bringing shareholder</li> </ul>                                                                                                                           | <ul style="list-style-type: none"> <li>• No restriction on individuals, institutions, and foreigners on the ownership of businesses</li> </ul>                                                                                                                                 | <ul style="list-style-type: none"> <li>• 65% of the total market capitalization consists of family businesses</li> <li>• Dominated by diversified business groups</li> </ul>                                                                                                                                                                                                                                                                    |

|                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| family, institutional and foreign owners | <p>activism</p> <ul style="list-style-type: none"> <li>• Institutional investors strongly reprimand non-adherence of CG</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                   | <ul style="list-style-type: none"> <li>• Foreign investors hold 53.2% of the value of the UK stock market at the end of 2012, up from 43.4% in 2010, 30.7% in 1998. Institutional down to 36.1%, from 46.3% and 52.8% on same dates</li> <li>• Role of institutional investors is rather strict</li> </ul>                                                                                                                                                                                            | <p>mainly family-owned business houses, usually in pyramidal form with a diverse set of businesses, often initiated by a single family, and bound together by equity cross ownership and common board membership</p> <ul style="list-style-type: none"> <li>• Foreign institutional investors may have a majority stake but must register with SEBI and Reserve Bank of India, even FIIs/NRIs/PIOs can hold 100% paid up capital in some companies</li> <li>• Institutional investors can be irresponsible and CG is not strengthened by capital</li> </ul>                                                                                                                        |
| Government corporation                   | <ul style="list-style-type: none"> <li>• 17 US Federal Government corporations, not publicly traded</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                       | <ul style="list-style-type: none"> <li>• 20 businesses, 100% owned by UK taxpayers, not publicly traded</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                    | <ul style="list-style-type: none"> <li>• Many publicly traded companies owned by state and central governments: 1,618 in 2006</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| CEO compensation                         | <ul style="list-style-type: none"> <li>• Must have a compensation committee of independent members of BODs if listed on national securities exchanges and national securities associations</li> <li>• US CEOs are paid more than their foreign counterparts: higher base salaries, larger bonuses, more stock options, and bigger chunks of company stock</li> <li>• US managers earn on average about twice as much as their UK counterparts with 50% higher cash bonus and three times higher equity-based compensation</li> </ul> | <ul style="list-style-type: none"> <li>• Boards must establish remuneration committee of at least three independent non-executive directors, or two in smaller companies</li> <li>• Majority of companies have remuneration committees to oversee pay-setting of top personnel</li> <li>• CEO pay levels have been growing, but still far behind USA</li> <li>• CEO pay is higher due to the presence of remuneration committees or with high proportions of outsiders on those committees</li> </ul> | <ul style="list-style-type: none"> <li>• Must have Remuneration Committee of Board, with at least three members, majority of whom are non-executive directors and at least one an independent director</li> <li>• Must form a Nomination and Remuneration Committee of three or more non-executive directors, at least one-half of which shall be independent</li> <li>• Remuneration is rather modest compared to the US and UK but is increasing significantly.</li> <li>• Most businesses are family owned or controlled, with managers appointed, promoted and rewarded according to relationships with the family and with limited role of remuneration committees</li> </ul> |

|                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
|------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Accounting, Auditing and Reporting | <ul style="list-style-type: none"> <li>• Accounting and auditing standards setting is delegated to the private sector, Financial Accounting Standards Board sets accounting standards</li> <li>• Public Company Accounting Oversight Board (PCAOB) oversees company' audits to protect shareholders' interest</li> <li>• Mandatory timely disclosure of financial information pertaining to business, compensations and any other transactions</li> <li>• CEO and CFO are responsible for reporting</li> <li>• Companies must rotate audit partners every 5 years</li> </ul> | <ul style="list-style-type: none"> <li>• Financial Reporting Council independently sets and enforces accounting and auditing standards</li> <li>• Internal financial controls of company monitored by an Audit Committee formed by Board</li> <li>• Combined Code of Corporate Governance has made the Boards responsible for timely financial disclosures and authenticity of financial statements</li> <li>• Board of directors responsible for reporting</li> <li>• Company auditors must be rotated every 5 years</li> </ul>             | <ul style="list-style-type: none"> <li>• Government sets and enforces accounting and auditing standards, with input from professional regulatory bodies, industry associations, SEBI, RBI, and Comptroller &amp; Auditor General</li> <li>• Timely and transparent disclosures have been started but auditing not yet up to US and UK standards</li> <li>• RBI blacklists auditors who do not comply with auditing policy</li> <li>• Both management and board of directors responsible for reporting</li> <li>• Board of directors responsible for reporting</li> <li>• Companies may appoint or reappoint a person as an auditor for maximum 5 years or an audit firm for two consecutive terms of 5 years, but then not in the same company for 5 more years</li> </ul> |
| Audit committee                    | <ul style="list-style-type: none"> <li>• Legislation for audit committee independence and financial expertise</li> <li>• Must have an audit committee with at least three directors, all of whom must be independent.</li> <li>• All members of audit committee must be financially literate or become so reasonably soon after appointment. At least one member must have accounting or financial management expertise</li> </ul>                                                                                                                                           | <ul style="list-style-type: none"> <li>• Audit committee recommended by Cadbury Report 1992 with very significant impact on auditor independence</li> <li>• The UK CG Code 2014 also requires companies to have: <ul style="list-style-type: none"> <li>- An audit committee of at least three, or in the case of smaller companies, two, independent non-executive directors (C.3.1)</li> <li>- At least one member of the audit committee has recent and relevant financial experience, but need not be independent</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Company must have an audit committee of at least three members with majority independent directors and also an independent director as the chairman of that committee</li> <li>• Majority of members of audit committee including Chairperson able to read and understand financial statements. All the members should have knowledge of financial management, accounting and auditing</li> </ul>                                                                                                                                                                                                                                                                                                                                 |

|                           |                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Litigation environment    | <ul style="list-style-type: none"> <li>• Class action lawsuits on behalf of shareholders</li> <li>• Strong plaintiff's legal representation available</li> <li>• Relatively efficient and creditor-friendly legal framework of bankruptcy and liquidation</li> </ul>                                                | <ul style="list-style-type: none"> <li>• Class action lawsuits not yet introduced</li> <li>• Control and discipline of errant directors relies on other legal, regulatory and informal devices</li> <li>• Creditor-friendly legal framework of bankruptcy and liquidation</li> </ul>                                                                           | <ul style="list-style-type: none"> <li>• Class action litigation recently introduced</li> <li>• Problems due to weaknesses in legal system.</li> <li>• Other legal provisions for company liquidation not creditor-friendly</li> <li>• New code aims to close wilful debt-default loophole, prevent defaulters from bidding for their own collapsed companies at auction, and smooth bankruptcy process. Insolvency and Bankruptcy Board of India, will oversee insolvency and bankruptcy related functions</li> </ul>                                                                                                    |
| Stakeholder relationships | <ul style="list-style-type: none"> <li>• Few mechanisms in place</li> <li>• Strong provision of incentives (awards) to whistleblowers who voluntarily provide SEC with original information about violation of securities laws</li> <li>• Statutory provision against retaliation against whistleblowers</li> </ul> | <ul style="list-style-type: none"> <li>• Hidden world of informal monitoring</li> <li>• Law protects individuals who disclose information in the public interest, and lets them bring action for victimisation and for connected purposes</li> <li>• Government encourages workers and others to whistle-blow about illegality or neglect of duties</li> </ul> | <ul style="list-style-type: none"> <li>• Companies must recognise the rights of stakeholders and encourage cooperation with them</li> <li>• Redress for violation of rights in civil and high courts possible but slow. Stakeholders can access information from company and stock exchange websites, but information quality varies</li> <li>• Companies with &gt;1,000 shareholders, debenture-holders, deposit-holders or other security holders to form a Stakeholders Relationship Committee to consider and resolve grievances</li> <li>• Whistleblowing is rare but is being encouraged by SEBI and MCA</li> </ul> |
| Market for finance        | <ul style="list-style-type: none"> <li>• Equity focused. Monitored by disclosure rules and the market for corporate control. Weak multiplex relationships – inter firm networks</li> </ul>                                                                                                                          | <ul style="list-style-type: none"> <li>• Equity (market) based financial systems, equity finance through active capital markets</li> </ul>                                                                                                                                                                                                                     | <ul style="list-style-type: none"> <li>• Fast growing stock markets but shareholdings remain rather concentrated with family groups and state enterprises</li> <li>• Equipped with encouraging changes in governance laws, but do not yet possess strong incentives to implement changes</li> </ul>                                                                                                                                                                                                                                                                                                                       |
| Market for labour         | <ul style="list-style-type: none"> <li>• Well developed business schools and consulting firms</li> </ul>                                                                                                                                                                                                            | <ul style="list-style-type: none"> <li>• Business schools and consultancy firms offer talent and help</li> </ul>                                                                                                                                                                                                                                               | <ul style="list-style-type: none"> <li>• Phenomenal increase in business and management education, from just 100</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |

|                                                     |                                                                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|-----------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                     | offer talent. Certified skills and welfare benefits enhance mobility                                                                                                                                             | flexible labour market but mobility low compared with USA                                                                                                                                                                                                                                                                                                                                  | business and management institutions in 1988, to 1,888 in 2005/06 (95,000 seats) and 3,858 in 2010/11 (360,000 seats), but quality has not kept up with numbers                                                                                                                                                                                                                                                                                                                        |
| Governmental regulations and Enforcement mechanisms | <ul style="list-style-type: none"> <li>• Determined mainly by legislation and detailed regulations</li> <li>• Based on strong compulsion. Also called “Comply or Die”. CG environment is “Rule-Based”</li> </ul> | <ul style="list-style-type: none"> <li>• Voluntary, with no judicial enforcement but possible sanctions by Stock Exchange for non-compliance. CG codes maintained and operated on a “comply or explain” basis</li> <li>• Financial Reporting Council identifies and regularly reviews good governance practices for board and committees, risk management, and internal control</li> </ul> | <ul style="list-style-type: none"> <li>• MCA and SEBI recommendations reflected in CG amendments, listing rules and regulations</li> <li>• Formerly on a “comply or explain” basis, but now most CG provisions are legally binding</li> <li>• Enforcement and implementation still challenging, particularly regarding role of nominee directors from financial institutions, stock-listing laws and regulations, insider trading, dividend and share transfer transactions</li> </ul> |

## **Chapter 4: Board Characteristics and Firm Performance: Evidence from India**

### **Abstract**

This study examines the relationship of several components of the board of directors with the performance of 150 large non-banking and non-finance companies in India using five years' unbalanced panel data from 2011 to 2015. Just before this period, the Security Exchange Board of India promulgated Corporate Governance Voluntary Guidelines 2009 that increased pressure upon firms to comply with the Voluntary Guidelines by separating the roles of CEO and chairman, reducing board busyness, applying limits on directors' tenure, setting policies for directors' remuneration or explain with reasons why they are unable to comply with the guidelines. The sample uses year-end market value capitalization as a measure of the size of a listed company. Data were obtained from multiple sources, with financial performance data are taken from Datastream and board characteristics compiled manually from BoardEx, companies' annual reports, and online sources. System Generalized Methods of Moments (System GMM) estimations are used to examine the relationship of the board of directors with firm performance measures, i.e. Tobin's Q, returns on equity (ROE), and returns on assets (ROA). The System GMM estimations help in mitigating the effects of potential endogeneity in CG research.

The paper finds a mixed result relating to the relationship of board characteristics with firm performance: a negative relation with board independence; no association with board busyness, nor board size, directors' remuneration, or board activities; and a negative relation of boardroom gender diversity. This paper expands theoretical understanding of the relationships between board characteristics and firm performance, using multiple theories, such as of agency, stewardship and resource-dependency, which recognize the various roles performed by the board of directors. Second, it provides empirical findings in India, particularly in the context of changing CG regulations and unique institutional settings.

Practically, the study has the potential to advise policymakers and regulators for normative changes in CG measures, such as for the appointment of women directors, voluntary provisions in determining board size, multiple board appointments, and board independence, facilitating a rational choice of CG measures.

Keywords:

Board of directors, board size, board busyness, CEO duality, board independence, board activities, boardroom gender diversity, directors' remuneration, firm performance, India

## **4.1. Introduction**

Whether a company's board of directors (BOD) has any significant impact on corporate performance has been hotly debated for a long time among scholars from diverse disciplines such as organization theory, management, economics, finance, and sociology. In the past, there were considerable disagreements regarding directors' roles; usually, managements used to dominate the boards of directors (Johnson et al., 1996). Some large corporate scandals around the world<sup>15</sup>, led to having closer scrutiny of the roles and compositions of BODs (Dalton and Dalton, 2005; Terjesen et al., 2016; Kumar and Zattoni, 2014). However, extant research on this issue provides inconsistent findings (Zahra and Pearce, 1989; 1990; Johnson et al., 1996; Dalton and Dalton, 2005).

The BOD serves two important functions for an organization, monitoring management on behalf of shareholders and providing resources (Hillman and Dalziel, 2003). As fiduciaries of shareholders, the BOD has to monitor management actions to ensure the interests of shareholders are protected (Zahra and Pearce, 1989; Johnson et al., 1996). Further, the BOD must scrutinize and approve strategic decisions, hire and agree on compensation

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<sup>15</sup> There have been a number of accounting irregularities and failure of internal controls and these include WorldCom and Enron (2001), Adelphia (2002), Parmalat (2003), Hollinger (2007), Tyco (2007), Lehman Brothers (2008), and more recently, Volkswagen (2015), Toshiba (2015).

policy for the senior management, and resolve any conflict of interest among decision-makers and residual risk bearers (Baysinger and Butler, 1985; Terjesen et al., 2016).

The characteristics of BODs are important drivers for the quality of CG and a firm's financial performance (Jackling and Johl, 2009). For example, a dual or unitary board leadership (CEO duality or separation) may affect the internal control systems (Jensen, 1993), firms' ability to adapt to a changing environment (Baliga et al., 1996) and surveillance against CEO entrenchment (Ramadani and Witteloostuijn, 2010). Larger boards can be beneficial in accessing critical information and resources that facilitate effective board functioning (Dalton and Dalton, 2005), or else they can be problematic due to poor communication and coordination, less flexibility, and inefficiency in decision-making (Eisenberg et al., 1998; Guest, 2009; DeAndres et al., 2005). The level of board independence can affect its ability to resolve any conflict of interests between the owners and managers (Jackling and Johl, 2009). Independent BODs are viewed as true monitors and resource providers and may offer better advice and counsel (Chen, 2011). As boards become increasingly independent of management, their monitoring effectiveness increases, thereby decreasing managerial opportunism and enhancing firm performance (Adams et al., 2010). Similarly, board busyness can compromise monitoring quality of BODs due to 'attention shocks' of overstretched directors (Jiraporn et al., 2009; Fich and Shivdasani, 2006; Falato et al., 2014). On the other hand, busy boards can be better connected and filled with more experienced directors (Field et al., 2013). Gender-diverse boards may make more effort to monitor managerial activities (Adams and Ferreira, 2009) and positively affect firm value (Farrell and Hersch, 2005). Likewise, other board characteristics, such as directors' age and tenure, may also affect board effectiveness and, in turn, affect financial performance. Hence, the board characteristics remain at the centre of policy debates as different countries attempt to develop legal and institutional frameworks to improve board performance (Kumar and Zattoni, 2014).

The paper examines the relationship between board characteristics and firm performance on a sample of about 150 publicly listed companies in India for over five years (2010/11 to

2014/15, with 149 to 155 sample companies). Before this period, in 2009, India introduced the ‘Corporate Governance Voluntary Guidelines 2009’<sup>16</sup> (the Voluntary Guidelines hereafter). The regulating bodies aim to improve the quality of CG standards and practices and retain the confidence of investors, which was severely damaged by the tremor of a big corporate scandal, i.e. the Satyam Computer Services Limited scam<sup>17</sup> in 2009, widely known as “India’s Enron”, which caused widespread public outrage and coverage by both Indian and Western media (Narayanaswamy et al., 2015). The Satyam failure led to questions about the quality of CG in India related to authorities and responsibilities of the board of directors, representation on the board, independence of directors and board committees, and relations between boards and executives (Dash, 2012). The Voluntary Guidelines offer flexibility to companies that can choose between complying with its principles or explaining why they do not (Arcot et al., 2010). The Voluntary Guidelines facilitate CG measures and encourage companies to ensure the quality and reliability of the information, and disclosures to create an efficient environment for controlling dominant shareholders. Companies are encouraged to adopt the spirit of the guidelines, rather than a box-ticking approach.

This paper contributes theoretically expanding understanding of the relations between board characteristics and firm performance by using multiple theories, such as agency, stewardship, and resource-dependency theories, which recognize the various roles performed by the board of directors. Secondly, the paper provides empirical findings in India about changing CG regulations primarily based on the ‘Corporate Governance

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<sup>16</sup> The Corporate Governance Voluntary Guidelines 2009 issued by the Ministry of Corporate Affairs in December 2009 which guides listed companies in a way that makes their business ethics transparent and accountable to shareholders. It broadly deals with the appointment of the board of directors, roles and responsibilities of the board, audit committees, the appointment of auditors, and whistle-blowing mechanisms.

<sup>17</sup> Satyam Computer Services Limited was a leading IT company that had more than a third of the Fortune 500 companies as its clients, with a workforce of 53,000 and operations in 66 countries spanning six continents, in 2009 (Atesci et al., 2010; Narayanaswamy et al., 2012). Its top management had committed a fraud of approximately US\$ 1 billion and had been inflating earnings and assets over eight years by systematically falsifying its accounts, which were undetected or overlooked by the auditors and board of directors for a long period (Rishi & Singh, 2011; Craig et al., 2013).

Voluntary Guidelines 2009'. These codes, relating to the board of directors, are unique to in India and not seen in the USA and UK (I compare and contrast among them in a later section). In India, with the changes in CG regulations, firms are expected to do better; however, the empirical evidence on this issue is limited and inconclusive. To the best of my knowledge, the Indian context for this period is unexplored in literature. Specifically, the paper investigates a wide variety of board characteristics, such as board size, independence, leadership style, busyness and activities, directors' remuneration, and so on, versus their implications on financial performance at the time when questions had been raised against the board's efficiency and integrity in overseeing and controlling managerial decisions (Rishi and Singh, 2011; Narayanswamy et al., 2015).

The paper also includes boardroom gender diversity, as one of the board characteristics examined, for its relationship with the performance of the sample companies. India is one of the first emerging economies to have an enforced quota<sup>18</sup> for at least one woman director on the BOD of any listed company. The effect of this legal intervention can be visible in the BODs of listed companies, increasing from 5.81per cent women directors in 2010/11 to 10.96per cent in 2014/15, and from 46.45 per cent companies with at least one woman director in 2010/11 to 85.91 per cent in 2014/15<sup>19</sup>. Although India has made a good start in promoting gender diversity on BODs via the regulatory push, the implication of gender diversity on firm performance has not been examined yet. The empirical findings of the paper may help to explain the objectives of the Ministry of Corporate Affairs behind the regulatory intervention for the representation of woman on the boards of directors in India.

The study has the potential to suggest how to change the practice of CG, particularly concerning board characteristics such as board leadership style, multiple directorships of directors, directors' independence and boardroom gender diversity. Policymakers can make

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<sup>18</sup> See the Companies Act 2013, Chapter XI, 149(b) and the Security Exchange Board of India (SEBI)'s Listing Obligations and Disclosure Requirements 2015, Regulation 17(1).

<sup>19</sup> See Table 4.1: Women Directors in Indian Boards, prepared from a sample of the largest companies in India.

rational choices of CG measures. I set out now to examine how the composition of a board of directors relates to the firm performance of listed companies in India:

*Do board characteristics affect firm performance?*

Section 4.2 provides a brief overview of the Indian institutional context leading to the rise of the Corporate Governance Voluntary Guidelines 2009. Important CG codes related to BODs provided by the Voluntary Guidelines are highlighted and compared with the USA and UK practices. An attempt has been made to show the uniqueness of Indian CG framework from the former two countries. Section 4.3 presents the theoretical framework of the study, followed by the review of relevant literature from around the world and from India in section 4.4. Section 4.5 discusses the data and methodology. It includes sources of data, variables of the study and regression models. In section 4.6, the paper presents the empirical results and analysis of the findings. Section 4.7 provides concluding remarks.

## **4.2. Why India?**

### **4.2.1. Institutional context in India**

India is one of the ten largest economies in the world, and it provides a useful empirical context to examine the CG system of an emerging economy (Chauhan et al., 2016). As of July 2014, India accounted for 17.5 per cent of world population, i.e. headcounts of 1.26 billion with a GDP of \$7.376 trillion measured. In terms of purchasing power parity that ranks India as the third-largest economy in the world (Branch and Khizer, 2016). India has been globalizing its businesses by listing companies on international stock exchanges, achieving rapid economic growth, emerging as one of the major economies, attracting huge foreign direct investment (FDI)<sup>20</sup>, and standing as an attractive investment destination to investors from all around the world. India's importance in the global economy is expected

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<sup>20</sup> According to UNCTAD report, India ranks 10th in FDI inflows in 2014 and 2015, with USA, Hong Kong (China), China (Mainland), Ireland, Netherlands, Switzerland, Singapore, Brazil, and Canada ahead of India in attracting FDI inflows in 2015. The FDI flow to India was \$2.7 billion in 2010/011, \$24 billion in 2012, \$28 billion in 2013, \$35 billion in 2014 and \$44 billion in 2015.

to grow in the future (Narayanaswamy et al. 2012). With its wealth and resources, India always remained a fertile country for entrepreneurial inception and foreign establishments. Hence, the needs of a fast-growing economy, the growing desire of Indian companies to access global capital markets by cross-listings, the increased presence of both domestic and foreign institutional investors have demanded a more transparent approach to CG in India (Jackling and Johl, 2009).

The Indian legal system originated from the English Common Law, which, theoretically, provides higher protection to investors and creditors. However, the judicial system, characterized by limited resources and long delays, fails to offer timely enforcement (Dharmapala and Khanna, 2013). According to Branch and Khizer (2016), bankruptcy framework was incompetent, arrantly disorganized and extremely time-consuming and resource-intensive. However, in May 2016, the Government of India enacted ‘The Insolvency and Bankruptcy Code, 2016’ (IBC). The IBC aims to close the wilful debt-default loophole, prevent defaulters from bidding for their own collapsed companies at auction, and ease and prompt the bankruptcy process, making it one of the world’s fastest bankruptcy regimes ([www.ft.com](http://www.ft.com))<sup>21</sup>. The IBC prescribed the establishment of Insolvency and Bankruptcy Board of India<sup>22</sup>, to perform all insolvency and bankruptcy related functions. The World Bank Group’s latest ‘Doing Business 2019’<sup>23</sup> report recognizes India as one of the top improvers in the Doing Business Ranking. India’s ranking was 130<sup>th</sup> in 2017, jumped to 100<sup>th</sup> in 2018 and to 77<sup>th</sup> in 2019, by improving its business regulations. India is continuing its steady shifts towards the best practice in business regulation.

India’s financial market is relatively more developed than in many other emerging countries. There are two big, well-functioning national stock exchanges, the Bombay Stock

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<sup>21</sup> See <https://www.ft.com/content/7babd578-493e-11e8-8ae9-4b5ddcca99b3> (Accessed 1 May 2019).

<sup>22</sup> See the Insolvency and Bankruptcy Code 2016 [186 (1)]. Available at <http://mca.gov.in/Ministry/pdf/TheInsolvencyandBankruptcyofIndia.pdf> (Accessed 1 May 2019).

<sup>23</sup> See ‘Doing Business 2019’ A World Bank Group Flagship Report. Available at [http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report\\_web-version.pdf](http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf), (Accessed 22 May 2019)

Exchange (BSE, established in 1875) and the National Stock Exchange (NSE, established in 1994), where more than 6,000 companies are listed (Chauhan et al., 2016). The BSE is ranked as the number one stock exchange in the world in terms of the number of companies traded, followed by LSE and NASDAQ, respectively. The NSE is ranked as the third-largest and BSE is ranked as the fourth-largest stock exchanges, respectively, in the world in terms of the number of trades, just behind NASDAQ and the NYSE (Chakrabarti et al., 2008). Recently in 2013, a third stock exchange MCX-SX has been established.

A key feature of the corporate sector in emerging economies, such as in India, is the dominance of family-owned and controlled firms with substantial founder ownership. Approximately 60 per cent of the 500 largest firms are part of family-owned firms, having 65 per cent of market capitalization value, and of which 53 per cent of the shareholding is held by founders or ‘promoters’ (Chakrabarti et al., 2008). In emerging economies, capital, labour, and product markets are characterized by high imperfections, and business groups are seen as remedies for resolving organizational problems (Zattoni et al., 2009). In the business groups, family members or simply controlling shareholders (principal owners) run multiple publicly listed companies and that controlling shareholders of business groups may abuse minority shareholders’ rights through pyramidal ownership and cross-holdings for their benefits (Bertrand et al., 2002; Bae et al., 2002). This context is different from the countries, such as the USA and UK, with relatively low ownership concentration and having a different type of agency (principal-agent) relationship (Thomsen et al., 2006). Because of the presence of intense secondary level agency (principal-principal) relationship, it is considered that the board characteristics are affected by the family ownership, and their group affiliation, such as board independence, tenure, diversity, busyness, and activities that affects the board behaviour in ensuring adherence to CG mechanisms and their impacts on firm performance because these characteristics are norms for emerging markets, like India (Chauhan et al., 2016). Hence, an investigation of the characteristics of boards as important drivers in CG and firm performance may provide insights for improvements in CG norms in an emerging economy.

The issuance of ‘Corporate Governance Voluntary Guidelines 2009’ by SEBI, based on ‘comply or explain’ approach, has increased pressure upon firms to comply with the Voluntary Guidelines by separating CEO-chairman roles, reducing the board busyness, applying limits on independent directors’ tenure, remunerating independent directors or explaining with reasons why they are unable to comply with the guidelines. The Voluntary Guidelines has four key provisions relating to the board of directors such as directors’ tenure, separation of CEO-chairman roles, directors’ directorship and directors’ remuneration. It is argued that these provisions would have significant effects on boards’ behaviour and ultimately on firm performance. The paper, therefore, examines the impact of board characteristics on firm performance within this regulatory framework.

#### **4.1.1.1. Corporate governance codes of the Voluntary Guidelines 2009**

Despite several initiatives in the past two decades to improve CG standards in India, none of them prevented the spectacular failure of Satyam Computer Services Limited in 2009 (Atesci et al., 2010; Narayanswamy et al., 2012). The Satyam fiasco raised serious questions about the implementation of CG norms in India and triggered the need for more transparency and stringent compliance of CG codes (Rishi and Singh, 2011). The CII formed a task force under the chairmanship of Naresh Chandra in February 2009 to recommend further improvements in CG standards and practices. In December 2009, the MCA issued the CG codes, namely ‘Corporate Governance- Voluntary Guidelines 2009’, incorporating the recommendations of Naresh Chandra Task Force set up by CII and consultations of wider stakeholders. The Voluntary Guidelines 2009 has summarised the set of CG rules as participatory governance, which aims to address CG issues in India. The voluntary recommendations are made on four areas of BODs, including the appointment of directors; independent directors, remuneration to directors and remuneration committee, and responsibilities of the board.

The Voluntary Guidelines recognise the board as a vital link between ownership and management as well as between principal owner and minority owners and therefore have a critical role and responsibility in the overall governance of the corporate sector (Varottil,

2010). The legislative and regulatory frameworks of CG in India, to some extent, are guided by the Anglo-American model. The Anglo-American corporate sectors are concentrated on agency problems between shareholders (owners) and managers (agents). However, in India, the CG problem is concentrated on disciplining the principal (dominant) shareholders and protecting minority shareholders. It was realised that this type of CG issue or abuses by principal shareholders could not be controlled by external governance mechanisms such as market forces and outside regulators. The following are some fundamental changes/provisions made by the Voluntary Guidelines 2009, especially related to the board of directors. These codes in India are compared and contrasted with the CG codes of the USA and UK.

***Separation of CEO-chairman roles:*** For the first time in India, the Voluntary Guidelines have provided a clear guideline to companies to separate the offices of chairman and MD/CEO offices. This provision is similar to the code in the UK that the same person should not exercise the roles of chairman and CEO in all UK listed companies, but in India, the code is applied only to listed companies with multiple businesses. In the USA, there is no such restriction or listing rule for the separation of roles. Instead, the US SEC requires each reporting company to disclose the board's leadership structure and why the company believes it is the best structure for them. From the separation of CEO and chairman roles, the Voluntary Guidelines in India intend to prevent a single individual from having unfettered decision-making power and intend to promote a balance of power between owners and management. Also, this may prevent the dominant shareholder from holding both roles and abusing minority shareholders. It can be argued that having separate individuals in CEO and chairman roles improves effectiveness in board monitoring and enhances firm performance.

***Directorship of directors:*** Initially 'the Desirable Corporate Governance: A Code' and Clause 49 of the Listing Agreement have restricted the maximum directorships an individual can hold to ten. The Voluntary Guidelines reduced this number to seven. They recommend that a managing director or whole-time director can serve as NED or ID in a

maximum of 7 companies. Independent directors are allowed to take a maximum of 20 directorships (maximum of ten listed companies). In this regard, the UK code is entirely different from the Indian code. According to the UK code, a full-time executive director cannot take more than one non-executive directorship of another company. In the USA, there is no such law or any listing requirement about the number of directorships of directors. However, the ISS US policy recommends that an individual director can take a maximum of six directorships and a CEO can take a maximum of two directorships of outside companies.

Compared with the USA and UK practices, the Indian Code allows the directors to hold more directorships of outside companies, with the potential to create busy boards. Busy boards may be detrimental for effective governance and firm performance (Harris and Shimizu, 2004; Fich and Shivdashi, 2006), as the firms need more monitoring than advising (Field et al., 2013). This study investigates whether the busy directors in India are detrimental to the quality of governance and corporate performance.

***Directors' tenure:*** The Voluntary Guidelines recommend a maximum tenure of 9 years for an individual director who can remain independent. An initial three years is considered as a cooling period for independent directors to be inducted in the same company in any capacity. In the UK, the Code recommends six years tenure for non-executive directors; if any non-executive director who wants to serve more than nine years should be re-elected annually. In the USA, there is no such law, regulation or listing rule that affects directors' terms in their office. Although NYSE listing rules provide that directors' terms in the office should not exceed three years, it is up to companies whether to put any term limits on their directors.

In terms of directors' tenure, the US practice is more flexible than in the UK and India. From agency theory perspective, the code provision of Voluntary Guidelines may encourage independent directors to have undue alliance with management and encourage them for managerial entrenchment because, as argued by Huang and Hilary (2018), in firms with short-tenured boards, the marginal effect of board learning dominates the

entrenchment effect, whereas in firms with long-tenured boards, the entrenchment effect dominates. Long-tenured directors compromise shareholder interests and appear to be a sign of CEO entrenchment. That will adversely affect the performance of the companies (Vafeas, 2003). In this study, the paper examines whether board tenure has any relationship with firm performance.

***Directors' remuneration:*** The Voluntary Guidelines have set clear guideline for listed companies in India about the remuneration of non-executive directors (NEDs) and independent directors (IDs). Companies may structure remunerations to NEDs by incorporating fixed components (not more than 1/3rd of the total remuneration packages) and variable components (based on attendance on board and committees). Similarly, IDs should be paid sitting fees and commissions (may be based on net worth and turnover of companies), but they are not allowed to be paid stock options and profit-based commissions.

In terms of the directors' remuneration, the UK and US regulatory models are converging (Suárez, 2012). In the UK, the Code recommends that levels of remuneration for NEDs should reflect their time commitment and responsibilities of the role. NEDs' remuneration should not include share options or other performance-related elements. Exceptionally, if NEDs receive options, shareholders' need to approve in advance. In the USA, the Securities and Exchange Commission (SEC) allows the boards of directors to determine NEDs' compensation. Any equity-based award plans for NEDs are subject to binding shareholder approval. NEDs are not permitted to participate in an ERISA (Employee Retirement Income Security Act) scheme because they are not employees of the companies.

Although it can be argued that the NEDs and IDs may be attracted to director's positions for other than pecuniary benefits, but empirical findings have shown that remuneration is an essential factor for their incentives (Adams and Ferreira, 2008). The USA and UK firms are allowed to pay their NEDs other than sitting fees, such as stock options with prior approval of shareholders. However, in India, NEDs and IDs are paid a tiny amount of sitting fees and a small amount of commission (only a few companies are paying it). Hence, in this study, it

is expected a different empirical link of directors' remuneration with the firm performance for Indian companies from that of the USA and UK.

In addition to the above CG codes of the Voluntary Guidelines 2009, some of the unique CG codes recommended by the Desirable Corporate Governance: A Code, Clause 49 of Listing Agreement, and the Companies Acts, that are relevant for my study, are briefly discussed below:

***Directors' independence:*** In India, the Desirable Corporate Governance: A Code in 1996 had first issued the provision of independent directors for listed companies with turnover exceeding Rs 1,000 crores that (a) 30 per cent IDs if the chairman is NED, (b) 50 per cent IDs if there is CEO duality. This requirement was later changed by Clause 49 of the Listing Agreement in 2000 and is still applicable to all listed companies in India. According to Clause 49, the board must have not less than 50 per cent NEDs. A company with non-executive chairman should have at least 33.33 per cent IDs; without a non-executive chairman or non-executive chairman from a promoter, it should have at least 50 per cent IDs. In the UK, the Code requires that in large companies the boards should comprise at least 50 per cent independent NEDs and in small companies at least two independent NEDs. Whereas in the USA, NYSE and NASDAQ require that the US companies must comprise a majority of IDs. However, controlled companies (with more than 50 per cent voting power held by an individual or a group or another company or foreign private issuers) are exempted from this requirement.

Board independence depends on the size of the firm in the UK and on the voting power of controlling shareholders in the USA, whereas in India, it depends on whether the board chairman is executive or non-executive. In this context, this paper expects a unique empirical link of board independence with firm performance in India than that of the USA and UK.

***Size of the board of directors:*** Initially, the Indian Companies Act 1956 required a company (with a minimum paid-up capital of 5 crore rupees or minimum shareholders of

1,000) to have at least three directors. The Companies Bill in 2003 amended this provision that a public limited company should have 3-15 directors. In the UK, the Companies Act 2006 requires a company to have at least two directors, but there is no upper limit. In the USA, the Delaware General Corporation Law (DGCL) requires that a company's board of directors should comprise a minimum of one director.

The comparison of code provisions for board size in the USA, UK and India reveals that the USA and UK codes are more flexible in determining board size of their listed companies. In this regard, the Indian code is less flexible, and in case of changing requirements, the companies cannot increase the number of board members easily. Hence, it can be argued that the rigidity in board size may adversely affect boards' behaviour and firm performance

***The number of board meetings and directors' attendance:*** Clause 49 of the Listing Agreement (in 2000) requires a company to hold a minimum of 4 board meetings in a year. There is no requirement of minimum attendance of directors, but the companies need to disclose directors' attendance on their annual reports. In the UK, there is no such mandatory rule for companies to have a minimum number of board and committee meetings. Companies are free to decide the number of meetings, but they are required to disclose the number of meetings and directors' attendance in their annual reports. In the USA, too, there is no definite rule for the number of board meetings and directors' attendance requirement.

The CG codes in India have directed the companies and their boards to have at least a certain number of meetings so that, as Vafeas (1999) argues, from the frequent meetings of directors, the outside directors will have more interaction time with inside directors to perform their monitoring roles. This study expects a positive empirical link of board activities, i.e. board meetings and directors' attendance with firm performance.

***Directors' age limit:*** Before the promulgation of Companies Act 2013, there was no guideline or any other mandatory rule in India for the age limit of directors. The Companies

Act 2013 requires a director's minimum age to be 21 years. Hence, from the middle of my sample period, the Indian companies started to feel the pressure of accounting for directors' ages while appointing board members. In the UK, a director must be at least 16 years old, and there is no prescribed maximum age limit for an individual to remain as a director. Similarly, in the USA, there is no statutory age limit imposed on directors of listed companies and companies are free to set any age limit for their directors.

With additional years in their lives, directors gain extra experience, get more chances to exercise and enhance their governance skills and are easily entrusted in resolving governance dilemmas (Rhodes, 1983). Also, the age of the directors affects their ability in taking risky decisions. In this paper, I examine whether the directors' age affects the quality of CG and firm performance.

#### **4.1.1.2. Boardroom gender diversity in India**

In India, women have reached into the dominant political positions after its Independence of 1947 such as the Prime Minister (Mrs. Indira Gandhi, 1966-1977 and 1980-1984) and the President (Mrs Pratibha Patil, 2007-2012). Also, some women from India have achieved tremendous recognition for their contributions to the business. For example, Ms. Chanda Kochhar (CEO, ICICI Bank), Ms. Chitra Ramkrishna (CEO, NSE), Ms. Shikha Sharma (Axis Banks), and Ms. Naina Lal Kidwai (HSBC Bank), who were listed on Fortune magazine's global list of top-50 women business leaders in 2013 (placed 4th, 17th, 32nd and 42nd, respectively). This progress of Indian women shows a resilient characteristic of Indian society, which indicates a promising future for positive change that can be brought for increased participation of women in senior managerial positions fighting against the traditional gender stereotypes (Budhwar et al., 2005). Being the largest democracy in the world, India has been remarkably progressive in many other spheres for women representation. However, Indian corporate boards are still way behind in rectifying the gender inequalities as they have a small number of women directors (Balasubramanian, 2013).

Catalyst (2014b) provides the statistics of women in senior managerial roles and board positions in India and around the world. Except in some top-ranked countries, such as Norway, Sweden and Finland, the imbalance of power in strategic decision making between men and women is pervasive around the world, which is deeply entrenched due to the poor representation of women in the top positions of the firms. Similarly, Indian corporate boards are the least gender-inclusive among the BRICKTS countries. In a survey report, Catalyst (2014a) shows just 4.7 per cent of board seats in India, only above that in South Korea (1.9 per cent), are held by women members, compared with 17.1 per cent in South Africa, 12.7 per cent in Turkey, 8.1 per cent in China, 7.7 per cent in Brazil, and 4.8 per cent in Russia (see Appendix 4A).

#### **4.1.1.3 Legislation for women's appointment on corporate boards**

Recently, the first time in India, the Companies Act 2013 mandated listed companies to have at least one woman director on their boards (The Companies Act 2013: 149. 1(b)). The Ministry of Corporate Affairs subsequently formulated rules<sup>24</sup> mandating every listed company to appoint at least one woman director. Further, every other public company, having paid-up share capital of one hundred crore rupees or more, or a turnover of three hundred crore rupees or more, must appoint at least one woman director on its board. The MCA further mandates in the rules that, “any intermittent vacancy of a women director shall be filled-up by the board at the earliest but not later than immediate next board meeting or three months from the date of such vacancy whichever is later”. Through this regulatory intervention, the Government has prioritized an increase in women's representation on the boards of listed and other public companies. The Government intends to reduce the social and labour grievances and injustices that women have traditionally experienced and which relegate them to smaller-scale and more mundane jobs. After the enactment of the Companies Act 2013, there has been a dramatic increase in the number of companies that appoint at least one woman director in 2014 and 2015. Rather than

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<sup>24</sup> Companies (Appointment and Qualifications of Directors) Rules, 2014, dated 31 March 2014 (Online). Available at [http://www.mca.gov.in/Ministry/pdf/NCARules\\_Chapter11.pdf](http://www.mca.gov.in/Ministry/pdf/NCARules_Chapter11.pdf). (Accessed 7 December 2018).

increasing the proportion of women on board of directors, Indian companies are just trying to comply with the new legal provision by appointing one or two token women directors. Table 4.1 below provides the trend of women's representation on the corporate boards of large Indian companies listed on BSE and NSE. It shows that 85.91 per cent of companies in 2015 have at least one woman director on their boards, a big leap from 58.39 per cent, 52 per cent, 51 per cent and 46 per cent in 2014, 2013, 2012 and 2011, respectively. Although the total percentage of women directors increased by 88.64 per cent over that time horizon (from 5.81 per cent in 2011 to 10.96 per cent in 2015), still the total number of women serving on boards of directors remains low.

**Table 4. 1: Women directors on Indian boards**

| Year | No of Firms | Boards with WD |    | Percentage |       | Boards with |           | % of boards with |           | Total            |           |          |
|------|-------------|----------------|----|------------|-------|-------------|-----------|------------------|-----------|------------------|-----------|----------|
|      |             | Yes            | No | Yes        | No    | One WD      | > one WDs | One WD           | > one WDs | No. of directors | No of WDs | % of WDs |
| 2011 | 155         | 72             | 83 | 46.45      | 53.55 | 52          | 20        | 33.55            | 12.90     | 1634             | 95        | 5.81     |
| 2012 | 149         | 76             | 73 | 51.01      | 48.99 | 51          | 25        | 34.23            | 16.78     | 1596             | 107       | 6.70     |
| 2013 | 151         | 79             | 72 | 52.32      | 47.68 | 54          | 25        | 35.76            | 16.56     | 1604             | 112       | 6.98     |
| 2014 | 149         | 87             | 62 | 58.39      | 41.61 | 63          | 24        | 42.28            | 16.11     | 1559             | 119       | 7.63     |
| 2015 | 149         | 128            | 21 | 85.91      | 14.09 | 102         | 26        | 68.46            | 17.45     | 1496             | 164       | 10.96    |

In 2015, 17.45 per cent companies have more than one woman directors on their boards which were 12.90 per cent, 16.78 per cent, 16.56 per cent, and 16.11 per cent in 2011, 2012, 2013, and 2014, respectively. Among them, only a couple of firms have 3 or more women directors that constitute, in the words of Torchia et al. (2011), a desired 'critical mass' to enhance the level of firm performance. The trend shows that the Indian corporations are just unwillingly complying with the legal requirements and they are less willing to increase the number of women directors on their boards.

The paper also investigates the impact of women's participation in corporate boards on firm performance in India. It asks whether the effect on financial performance is positive. India is one of the largest emerging economies with having rapid economic growths. India is a

diverse nation with multiple religions, languages, social classes and ethnicities (Budhwar, 2009), but, despite remarkable progress in many spheres, India is slow to rectify the gender inequalities that still persist (Balasubramanian, 2013). Through regulatory intervention, such as passing Corporate Governance Voluntary Guidelines 2009 and enactment of the Companies Act 2013, India intends to break through the historic barriers by mandating listed companies to increase women's participation in corporate boardrooms. However, the economic impact of gender diversity on corporate boards in the Indian context has not been properly examined yet.

### **4.3. Theoretical framework**

No single theory is enough to explain the general pattern of the relationship between the board of directors and firm performance (Nicholson and Kiel, 2007). Leading theories include the agency theory (Jensen and Meckling, 1976), the resource-dependence theory (Pfeffer and Salancik, 1978), and the stewardship theory (Davis et al., 1997). The theoretical focus of much of the extant literature has been on agency theory in characterising the principal-agent and principal-principal relationships and their implications for CG.

Agency theory of Jensen and Meckling (1976) posits that effective CG is required to avoid conflicts of interest between the principal (owners who delegate work) to the agent (management). The pivots for the development of agency theory rest on the difference in ownership and control in modern firms. With the growth in the size of the modern corporations, the share ownerships are widely held, and the shareholders (principals) have little control, so they rely on professional managers (agents) to protect their interests. In practice, though managers tend to act in their self-interest, the board of directors plays an important role by monitoring and preventing opportunistic and self-centred behaviour of managers. However, agency theory has been criticised since it views managers as individualistic, opportunistic, and self-serving human beings (Fox and Hamilton, 1994; Davis et al., 1997). Alternative paradigms for the study of board characteristics that have been proposed in the extant literature are briefly discussed below.

The second major theory of CG is resource dependency. Pfeffer and Salancik (1978) propose the resource dependence theory where a board of directors provide critical resources to the business. Agency theory suggests that effective monitoring is the key function of the board, whereas resource dependence theory argues that provision of resources is the key function of the board. Hillman and Dalziel (2003) utilise the resource dependence idea, where the board is considered as a provider of valuable resources to the firm via human and relational capital. Human capital consists of knowledge, skills,

entrepreneurial and financial experience, technical experience, and reputation whereas the relational capital (also known as social capital) is about the vital resource arising from the network of the board of directors with the external environment (Dalziel et al., 2011). Competition, changing regulations and other social forces cause firms to strengthen linkages with the external environment to access and exercise control over resources (Boyd, 1990). Hence, the integration of diverse constituencies and stakeholders to make the board more inclusive improves the organization's ability to acquire both external and internal critical resources that bring economic benefits. Pfeffer and Salancik (1978) categorise such benefits into four types: (1) advice and counsel, (2) legitimacy, (3) access to channels of information, and (4) preferential access to resources. Thus, according to this theory, the board's size and composition are not decided randomly but are the result of rational organizational responses to environmental pressure in acquiring scarce resources (Hillman et al., 2009).

Davis et al. (1997) propose the stewardship theory where company executives and managers work as stewards for the shareholders. In contrast to the agency theory, the emphasis in stewardship theory is on the role of top management rather than individuals. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. Unlike the agency theory, managers are not motivated by self-serving interests but they are seen as trustworthy individuals and so are good stewards of resources (Donaldson and Davis, 1991; Muth and Donaldson, 1998; Davis et al., 1997; Fox and Hamilton, 1994). They understand the businesses more closely and can make better decisions than any outsiders. Thus, shareholder interests can be best served by an appropriately designed organization structure and incentive plans that would allow managers to take effective actions (Donaldson, 1990).

In terms of boardroom gender diversity, academic debates are divided into two theoretical perspectives, ethical and economic (Campbell and Mínguez-Vera, 2008). From the ethical point of view, it is immoral or unethical to exclude women from decision-making because of their gender; hence the firms need to increase women's participation on senior

management and boards to create a fairer and more equitable society. Alternatively, from the economic point of view, the underrepresentation of women in senior management and boards makes firms fail to acquire the ablest individuals for these positions, and thereby harm their financial performance. Gregory-Smith et al. (2014) suggest two further aspects of the economic case for gender diversity: the direct costs of discrimination versus improved-decision making and hence better performance.

From the above discussion, it is obvious that no single theory offers a perfect prescription that would ensure effective monitoring of management's activities and stewardship of owners' interests. Agency, stewardship, and resource-dependence theories assist to understand the roles to be played by the board of directors in contributing to the firm performance (Nicholson and Kiel, 2007). The best theoretical paradigm depends upon the surrounding environment, stage of firms' life cycle, the relative power of stakeholders (Lynall et al., 2003), general industry conditions, industry homogeneity, and regulation (Palia, 2000).

#### **4.4. Literature review and hypotheses development**

##### **Board size and firm performance**

The empirical evidence on the link between board size and firm performance is inconclusive and contradictory. A body of research suggests that larger boards are associated with higher firm performance because larger boards have directors with diverse educational and industrial backgrounds, plus skills and experiences with multiple perspectives, which improve decision making (see for example, Pfeffer (1972), Dalton et al. (1999), Dalton and Dalton (2005), Goodstein et al. (1994), Pearce and Zahra (1992), Klein (2002), and Coles et al. (2008)). Based on the resource-dependency theory of CG, larger boards facilitate effective interaction with the external environment and wider access to various resources which positively impacts firm performance. In a meta-analysis of 131 studies, Dalton and Dalton (2005) conclude that larger boards provide greater access to resources and networking opportunities through their diversity of experience, skill, gender

and race. Chaganti et al. (1985) suggest that though firms with relatively larger boards have greater possibilities of survival, managing larger boards can be difficult. Alternatively, based on the agency theory of CG, many papers report that smaller boards are more effective and positively affect firm performance, while larger boards suffer from the lack of coordination and communication problems and are less likely to monitor performance effectively (see for example, Jensen (1993), Yermack (1996), Eisenberget al. (1998), Conyon and Peck (1998), DeAndreset al. (2005), Boone et al. (2007), Cheng (2008), and O'Connell and Cramer (2010)).

In the Indian context, a few studies have investigated the relationship between board size and its impact on CG and firm performance. Ghosh, A. (2006), and Kumar and Singh (2013) find a negative association among them. They conclude that larger boards are not efficient in monitoring firm performance. In contrast, Jackling and Johl (2009) and Jameson et al. (2014) find the relationship between board size and firm performance is positive and significant. They argue that larger boards bring a greater depth of intellectual knowledge and hence improve decision making and in turn improve performance. Sarkar and Sarkar (2009) do not find any significant relation between board size and firm value. In this equivocal situation, the Companies Act 2013 has set a limit for the board size of listed companies<sup>25</sup>, which gives companies some flexibility in determining their board size. However, there is still a dearth of systematic studies on board size, showing clear advice to Indian companies whether to have larger or smaller boards, hence following the null hypothesis:

*Hypothesis 1: There is no association between board size and firm performance in India.*

### **Board independence and firm performance**

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<sup>25</sup>The Companies Act 2013 set a limit for a company to have 3 to 15 directors. However, a company is allowed to appoint more directors provided a special resolution approved by the majority of shareholders.

As suggested by Jensen and Meckling (1976), agency problems arise due to the separation of corporate ownership and management. The board of directors represents the owners' interest as the internal control mechanism responsible for monitoring management activities. Board independence increases the board's ability to monitor management effectively (Beasley, 1996). The appropriate mixture of various types of individuals as members of the boards of directors of companies is considered as one of the keys for organizational monitoring mechanisms (Baysinger and Butler, 1985). A number of papers argue that the appropriate mix of independent directors helps in closely and effectively monitoring and evaluating the senior management's behaviour, performance and compensation and helps develop and implement successful strategies thus contributing to the higher firm performance [Fama and Jensen (1983), Daily and Dalton (1995), Hillman and Dalziel (2003), McDonald et al. (2008), Chhaochharia and Grinstein (2009), Adams et al. (2010), Ozkan (2011), Bhagat and Bolton (2013)].

On the other hand, Yermack (1996), Agrawal and Knoeber (1996), and Coles et al. (2001) show that board independence has negative effects on the firms' market performance. A higher proportion of board independence adversely affects the board's dynamics and ultimately the firm's performance. Zahra and Pearce (1989 & 1990) contend that boards having more outside directors may hinder firm performance because of their busyness and focus on issues of efficiency rather than long-term effectiveness, as well as lack of knowledge of industry conditions and firm operations. Dalton and Dalton (2005), argue that board independence does not guarantee firm performance and directors are required to perform multiple roles for higher firm performance. Further, Duchin et al. (2010) argue that the independent directors' impact on firm performance depends on how costly it is for independent directors to become informed about the firm. When such costs are low, the firm's financial performance increases.

Sarkar et al. (2008), in a sample of 500 large Indian companies for two years' data i.e. 2004 and 2005, examine the relationship between board characteristics, i.e. board independence and board quality (in the form of four variables: board busyness, board diligence,

promoters' influence, and CEO duality) with the firms' opportunistic earnings management. They find that board quality is more important than board independence in affecting firms' opportunistic earnings management. Jameson et al. (2014) investigate whether the board independence mitigates the negative performance effect of two types of controlling shareholders, families and founders that dominate the boards of directors of Indian companies. They find no evidence that board independence is effective in mitigating negative effects due to the presence of controlling shareholders. But Jackling and Johl (2009) show that outside directors with multiple appointments (busy independent directors) have negative effects on firm performance, suggesting that busyness does not add value in terms of networks and enhancement of resource accessibility. They argue that the weaker association of outside directors with performance might be due to the strong influence of family members, lack of independence of outside directors, and weak and inactive monitoring roles of independent directors that could be evidenced from the failure of Satyam Computers in 2009. In contrast, Sarkar and Sarkar (2009), and Jameson et al. (2014) suggest that independent directors with multiple appointments i.e. directors' busyness, can give a positive impact on company performance because busy independent directors are likely to be more committed to their governance role. Hence, still, there is no clear empirical finding to advise Indian companies whether to increase the number of non-executive and independent directors for better firm performance. The regulatory framework is mandating to have greater board independence<sup>26</sup>, but that is not supported by the existing but limited number of studies for board composition in corporate India. Hence the following null hypothesis:

*Hypothesis 2: Board independence is not associated with firm performance in India.*

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<sup>26</sup> The SEBI's Clause 49 of the Listing Agreement and the Companies Act 2013 requires the board of directors of a company to have at least one-half of non-executive directors, who need not to be independent directors. But the number of independent directors on the board depends on whether the company's chairman is executive or non-executive, "company with non-executive Chairman – must have at least one-third (33.33%) independent directors; company without non-executive Chairman or non-executive Chairman from promoter – at least one-half (50%) directors should be independent."

## **Directors' remuneration and firm performance**

Directors' remuneration is one of the most intensely researched topics in CG, and, perhaps, least understood areas of management (Kakabadse et al., 2004). It is the matter of concern to widespread stakeholders of the companies such as the investors, regulators, bankers, shareholders, media and the general public. Academics also have a considerable interest to find a relationship between the level of executive pay and corporate performance. However, evidence on the link between directors' remuneration and firm performance is generally inconclusive.

Adams and Ferreira (2008) examine the impacts of compensation on the director's attendance. They argue that many companies reward their directors, especially non-executive and independent directors, with a modest sitting fee for each board meeting they attend based on the notion that people respond to the monetary incentive. They find small monetary rewards to the independent directors do not strongly influence their behaviour. Instead, firm size and efforts in preserving and enhancing director reputation are the primary motivational incentives to the directors. Benito and Conyon (1999) examine the link between directors' pay and the stock-market performance of UK companies between 1985 and 1994 and find that directors' compensation is positively related to pre-dated shareholder returns and company size. But in contrast Brick et al. (2006) find that excessive compensations to the executives (both directors and CEO) are associated with firm underperformance, as it comes with an environment of ineffective monitoring due to back-scratching or cronyism between CEO and directors. Similarly, Goh and Gupta (2016) find in a large sample of FTSE companies that "director remuneration is negatively related to monitoring characteristics such as director independence, suggesting possible agency considerations, as effective monitors of top management, are paid less" (pp. 1). Doucouliagos et al. (2007) explored the relationship between directors' pay and performance within the Australian banking sector and find that the directors' pay does not appear to be associated to contemporaneous performance such as earnings per share and ROE with a one year lag. However, they find a more distant pay and performance

relationship i.e. links between directors' pay and performance as measured by EPS and ROE with a two-year lag. Similarly, Ye (2014) examines the impact of compensation to independent directors on firms' financial reporting quality in China and reports a positive association between independent directors' cash compensation and the magnitude of earnings management. The payment of higher cash compensation to independent directors impairs their independence and cannot motivate them in the oversight of the financial reporting process.

Canyon (1995) assessed the link between directors' remuneration and measures of company performance: total shareholder return, return on shareholders' equity, return on long-term capital, and earnings per share of leading UK privatized utilities. The findings show an insignificant relationship between directors' pay and all four measures of corporate performance. Gregg et al. (1993) also find no relationship between directors' compensation and firm performance of 300 large British companies in the late 1980s and early 1990s. During that period directors have been enjoying considerably higher growth in their pay, i.e. 20 per cent per year in average, which appears to be unrelated to the firm performance as measured by the market price of equity shares and dividend returns. Directors' remuneration is driven by the firm size but not by financial performance.

In emerging economies like India, most studies on executive compensation mainly focus on CEO compensation but board compensation is relatively ignored in the literature (Ghosh, A., 2006; Ghosh, S., 2006). In India, the remuneration of non-executive and independent directors is determined by the boards and duly approved by the shareholders. But in government companies the appointment of board members and their remuneration are determined by the government, hence, most government companies do not have remuneration and nomination committees of the board members. Unlike in the USA and UK, where most companies provide their independent and non-executive directors higher amount of performance-based incentives in the form of equity shares and options, most Indian companies pay only with a moderate amount of cash for their roles as the directors.

This context offers good scope for examining the impact of independent and non-executive directors' compensation on firm performance. Hence the following null hypothesis:

*Hypothesis 3: There is no link between directors' compensation and firm performance in India.*

### **Directors' tenure and firm performance**

The resource dependency theory on directors' tenure suggests that length of time directors serve on a board can affect the quality of a board's effectiveness in monitoring management and their tenure reflects the company-specific knowledge and experience of directors (Kesner, 1988; Bilimoria and Piderit, 1994). Vafeas (2003), and Byrd and Cooperman (2010) have explained two hypotheses about directors' tenure, i.e. expertise hypothesis and allegiance hypothesis. According to the expertise hypothesis, longer tenure leads to greater firm and industry knowledge, and thereby, superior monitoring by the board. But, as per the allegiance hypothesis, the directors with longer tenure become more familiar with the CEO and align their interest in favour of the CEO rather than looking after shareholders' interests.

Vafeas (2003) find that an increase in board tenure is associated with greater committee participation of directors. However extreme lengths of board tenure may be detrimental to the interests of shareholders as senior directors may compromise shareholders' interests by cronyism with the CEO and, consequently, ineffective monitoring. Similarly, McIntyre et al. (2007) also suggest that a moderate level of board tenure positively affects firm performance as board members need some time to adjust to a board to contribute, however, their contributions tend to diminish with longer tenure. Hence, these findings highlight the need for policy reform to limit directors' tenure in their role. Angbazo and Narayanan (1997) examine the impact of inside and outside directors' tenures on board effectiveness and their relationship with the management. Inside directors who have long tenure are likely to have greater influence and seniority on the board, which makes it more difficult for the outside directors to replace them or other members of their management team,

leading to managerial entrenchment. On the one hand, outside directors with longer tenure can gain monitoring experience and are likely to be more effective in monitoring managers, but, on the other hand, they can be ineffective if they entrench themselves becoming too close to the management. Compared to new directors, a director with longer tenure on the board may have stronger identification with the shareholders, customers/suppliers, identities of being a director, being a CEO (for a director with CEO duality) and being a shareholder. Because of the strong identification they provide additional resources or monitor management to bring maximum benefits to the organization (Hillman et al., 2008).

In India, the Ministry of Corporate Affairs introduced a new Companies Act in 2013 limiting the terms of the board of directors of listed companies. According to the Companies Act, 2013 and Corporate Governance Voluntary Guidelines 2009, the maximum tenure of non-executive directors is 6 years (plus 3 years' cooling period) and 5 years' tenure for independent directors (plus 3 years cooling period). No study has been found in India about the impact of directors' terms in the office on firm performance. Also, the academic findings from around the world are equivocal. Hence the following null hypothesis:

*Hypothesis 4: Board of directors' tenure is not associated with firm performance in India.*

### **Directors' age and firm performance**

Age reflects directors' general business experience, background and evidence of their maturity in directing the business (Hafsi and Turgut, 2013; Bilimoria and Piderit, 1994). Age effects are developmental in nature and affect work attitudes and behaviours. It may bring psychological changes such as changes in personality, needs, expectations, and behaviours as well as performance (Rhodes, 1983). With additional years in their lives, directors gain extra experience, get more chances to exercise and enhance their governance skills and are easily entrusted in resolving governance dilemmas. Houle (1993) contends that the boards of directors should have age diversity, as the older board members have more experience, wisdom, and resources and the middle-aged members can help in

developing outside relationship whereas the younger members could use their energy and drive for a firm's success. On the other hand, Ferris et al. (2003) argue that older directors might pose a last-period risk to the firm as they might seek to maximize their income in retirement or might seek more lucrative part-time appointments or they might have the poor motivation to work hard when they are near retirement.

Relatively few studies examine the association between directors' age and board activities and firm performance. For example, Wiersema and Bantel (1992) find that management teams that have younger members are more aggressive and more likely to undergo major strategic changes. Mahadeo et al. (2012) find directors' age diversity as a positive factor for firm performance as measured by ROA. In contrast, Hafsi and Turgut (2013) find a negative effect of age diversity on corporate social performance in a sample of 95 companies from S&P 500 firms.

In India, according to the Company Act 2013, "No company shall appoint or continue the employment of any person as managing director, whole-time director or manager who is below the age of twenty-one year or has attained the age of seventy years" (pp. 119). Now, it is an interesting issue to investigate whether the average age of directors has any association with the firm performance of Indian companies. Hence the following null hypothesis:

*Hypothesis 5: Average age of the board of directors does not affect firm performance in India.*

### **CEO duality and firm performance**

Organization theorists believe that CEO duality results in strong and unambiguous leadership but agency theorists argue that duality promotes CEO entrenchment by reducing the board's monitoring effectiveness (Finkelstein and D'Aveni, 1994). Many authors argue for and against CEO duality. Some of them strongly advocate for splitting of CEO and chairman roles, that reduces the adverse impact of CEO entrenchment, and enhances

transparency and firm performance [see for example, Pi and Timme (1993), Rechner and Dalton (1991), Dalton and Dalton (2005), Simpson and Gleason (1999), Goyal and Park (2002), and Adams et al. (2005)]. In contrast, Mallette and Fowler (1992), Fosberg and Nelson (1999), Brickley et al. (1997), Donaldson and Davis (1991), Ramdani and Witteloostuijin (2010) and Dey et al. (2011) document evidence supporting the claims of stewardship theory that CEO duality provides better stewardship of firm resources and thus is positively associated with firms' financial performance.

Although the proponents and opponents of CEO duality attack each other with its pros and cons, there is a stream of papers which do not find any tangible evidence of CEO duality affecting firm performance [see for example, Rechner and Dalton (1989), Daily and Dalton (1992; 1993; 1994a), Daily (1995), Judge and Dobbins (1995), Baliga et al. (1996), Dalton et al. (1998), Elsayed (2007), and Fosberg (1999)]. CEO leadership style alone does not affect firm performance. They argue that there are other important factors than CEO leadership style, which, combined, significantly affect firm performance. On the other hand, Finkelstein and D'Aveni (1994), Boyd (1995), Kang and Zardkoohi (2005), and Boyd et al. (2011) suggest that there is no universal optimal board leadership structure and companies should select the most appropriate model depending on their circumstances. For example, a vigilant board is more likely to adopt the CEO duality structure when CEO's dominant power and firm performance are low; in this circumstance, the benefits of the unity of command from a CEO outweigh the risks of CEO entrenchment and vice versa (Finkelstein and D'Aveni, 1994).

In India, very few studies have tried to attempt this issue, but none of them has shown a clear link between the board leadership structure and firm performance. Balasubramanian et al. (2010) find a majority (i.e. 59 per cent) firms have separate individuals as CEO and chairman. However, the paper does not examine the relationship of CEO duality with the firms' financial performance. Jackling and Johl (2009), and Jameson et al. (2014) find no significant difference from CEO duality or non-duality on the performance of India's top companies. Ramaswamy et al. (2000), in a study of 150 manufacturing companies in India,

find a positive link between CEO duality and CEO compensation but the paper does not attempt to examine the impact of CEO duality on firm performance. Sarkar et al. (2008) argue that CEO duality is vital in improving the financial reporting environment and earnings management. The paper contends that CEO duality increases the opportunistic earnings management to conceal the correct financial position of their companies, which compromises the quality of financial disclosure and financial reporting. However, they remain silent on the relationship between CEO duality and firm performance. Hence the following null hypothesis:

*Hypothesis 6: CEO duality has no association with firm performance in India.*

### **Directors' busyness and firm performance**

The theoretical argument about directors' busyness is linked with the resource dependency theory as directors with multiple board appointments have a high level of engagement with the external environment and provide access to various resources (Jackling and Johl, 2009). Directors are not only required to monitor management and attend board meetings, but also they are required to commit time and resources and to be more proactive and knowledgeable about their companies. However, studies in the past failed to show any significant pattern between directors' busyness and firm performance (Andres et al., 2013).

Some argue that busyness certifies directors' ability and such directors are value-enhancing to a firm. For example, Harris and Shimizu, (2004), Field et al. (2013) view that busy directors offer advantages for many firms as their experience and contacts arguably make them excellent advisers (Field et al., 2013). Di Pietra et al. (2008) find that directors' busyness has a positive and statistically significant influence on firms' market performance in Italy as the investors find busy directors to be well connected with reputable links and are therefore viewed as more effective in signalling success in the capital markets. Masulis and Mobbs (2014) revealed that busy directors are not equally detrimental for all firms; however, they face a dilemma of how to allocate their limited time and energy across their boards.

Others criticize busy directors as being overstretched and ineffective in monitoring the management and detrimental for the firm. For example, Core et al. (1999), Shivdasaini and Yermack (1999), Sharma, (2011), Cashman et al. (2012), Andres et al. (2013), Jiraporn et al. (2009) show a negative association between the presence of busy directors and firm performance. Fich and Shivdasaini (2006) find that firms with busy boards are associated with poorer CG, lower market-to-book ratios, weaker profitability and lower sensitivity of CEO turnover to firm performance. Similarly, Falato et al. (2014) provide evidence that directors' busyness is detrimental to the board monitoring quality and ultimately to firm performance. Jensen (1993) and Devos et al. (2009) argue that firms with busy directors may entrench management, so that directors perform monitoring roles ineffectively, leading to weak governance. CG policymakers have therefore imposed limits on the number of directorships held by independent directors. In contrast, Ferris et al. (2003) find no evidence that multiple directorships have a deleterious impact on board effectiveness and subsequently on firm performance. If non-busy boards are as effective as busy boards in monitoring management, hence, proposals encouraging limits on multiple board appointments are unwise.

In India, Sarkar and Sarkar (2009) find mixed results about the impact of directors' busyness on firm performance. They investigate the busyness of inside and outside directors and contend that busyness of outside directors has a positive relationship with firm performance, but the busyness of inside directors has a negative relationship with firm performance. In contrast, Jackling and Johl (2009) report that busy directors have negative impacts on firm performance, suggesting that directors' busyness does not add value in terms of networks and enhancement of resource accessibility. They argue that the weaker association of directors' busyness with firm performance might be due to the strong influence of controlling family members, lack of independence, and weak and inactive monitoring roles of directors as in the failure of Satyam Computers in 2009. Indian legislation such as the Companies Act 2013, Clause 49 of the Listing Agreements, and Voluntary Guidelines 2009 have set flexible but contradictory limits for directors' multiple

board appointments<sup>27</sup>. However, there is a lack of empirical support for regulatory intervention to limit the multiple directorships of the directors. Hence the following null hypothesis:

*Hypothesis 7: Directors' busyness has no association with firm performance in India.*

### **Board activities (board meetings and board attendance) and firm performance:**

The intensity of board activities is an important dimension of board operations (Vafeas, 1999). Board activities, as measured by the frequency of board meetings and directors' attendance, at face value, may bring important resources and may influence the governance nexus, linked with resource dependency theory of CG (Jackling and Johl, 2009). Vafeas (1999) argue that a higher frequency of boards meetings can be a remedy for limited director interaction. It provides board members with the chance to come together, discuss and exchange ideas on how they wish to monitor managers and formulate corporate strategies.

Jensen (1993), and Vafeas (1999) document that reactive boards increase the frequency of meetings as a response to turmoil in the firm, which in turn relates to the improved firm performance. Jensen (1993) further argues that board meetings may not be useful because of the limited time given to the meetings, and they cannot lead to a meaningful exchange of ideas among directors or with managers. However, proactive boards strategically increase the timing and frequency of board meetings to bring resources to prevent a crisis. DeAndres and Vallelado (2008) view that the more frequent the meetings, the more relevant the advisory role, factors that could lead to a positive impact on performance.

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<sup>27</sup>Total directorship a person can take is 20 but can have a maximum of 10 directorships of listed companies (the Companies Act 2013). But as per Clause 49, the independent directorship for a person is limited to 7 listed companies. A Managing Director or Whole-time Director can serve as a non-executive or independent director in a maximum of 7 companies (CG Voluntary Guidelines 2009) but Clause 49 limits to 3 listed companies.

The frequency of board meetings is meaningless unless board members attend the meetings. Physical attendance of directors provides them opportunities for interacting, advising and formulating strategies which may link to the firm performance. Lin et al. (2014) find that higher board attendance enhances firm performance, that firms could view the attendance rate as an indication of directors' commitment and the quality of the board supervision of these corporate monitors. Board attendance relates to directors' busyness. Multiple directorships are the main reason for directors' absences from board meetings as they are unable to balance their time and efforts, creating difficulties in fulfilling responsibilities of a director adequately (Jiraporn et al., 2009; Ferris et al., 2003).

Similarly, Masulis et al. (2012), for US companies, examine the benefits and costs of foreign independent directors. They find that the foreign independent directors have poor board meeting attendance records that encourage internal directors engaging in intentional financial misreporting, paying their CEOs and executives excessively high compensation, and showing less sensitivity in replacing weak CEOs. Hahn and Lasfer (2016) confirm the above findings of Masulis et al. (2012) from the study of UK companies. However, there is no empirical evidence showing links between directors' average attendance in board meetings and firm performance.

In the Indian context, very few studies focus on boards' activities and their impacts on firm performance. Jackling and Juhl (2009), for listed companies India, attempt to examine the association of board meeting frequencies with the performance. They report that the relationship between board meeting frequency and performance may be more complicated than a mere linear relationship. According to the Companies Act 2013 and Clause 49 of the Listing Agreement, Indian listed companies are required to have at least four board meetings in a year, but there is no upper limit for the number of meetings. Hence the following null hypotheses:

*Hypothesis 8: Board meeting frequencies and directors' board meeting attendance are not associated with firm performance in India.*

## **Boardroom gender diversity and firm performance**

Although prior studies have attempted to examine the impact of women in upper echelon on firm performance, there is a remarkable lack of consensus among them (Isidro and Sobral, 2015). They failed to produce consistent results on this issue. Welbourne et al. (2007), Carter et al. (2003), and Erhardt et al. (2003), all for US firms, find that boardroom gender diversity has a significant positive association with a performance indicator (Tobin's Q). Likewise, Ali et al. (2014), for Australian firms, report that a higher level of boardroom gender diversity results in higher employee productivity. Furthermore, Francoeur et al. (2008), for the sample of 230 firms from FP500, i.e. 500 largest Canadian firms, find that the firms operating in complex environments have positive and significant abnormal returns when they have a high percentage of women executives. They further contend that women's participation only on the boards of directors does not make any difference to firm performance. However, if a high proportion of women in both their management and boards exist (governance systems), the companies can generate enough value to keep up with reasonable stock-market returns.

Mahadeo et al. (2012), based on a sample of listed companies in Mauritius, argue that female representation on the corporate boards in developing countries is very low, and the very few appointments of women as board members have been made are just tokenistic. However, the regression model provides an encouraging result relating to female representation, i.e. a positive relationship between gender diversity and ROA. Srinidhi et al. (2011), in a sample of US corporations, find that firms with greater female participation on boards exhibit higher earnings quality as a consequence of a higher level of monitoring. Better earnings are the outcome of good governance and more women on boards of directors, enhancing the oversight functions of the boards.

However, the presence of women on boards may not always be beneficial. Despite finding a positive impact on firm value from the gender balance on boards of Spanish companies, Campbell and Mínguez-Vera (2008) argue that it could happen if women bring additional perspective to management and board decision-making. Alternatively, women may bring a

negative impact if the decision to appoint female senior executives and board members is just motivated by societal pressure only for the sake of greater equality of the sexes. Women's representation merely for gender diversity does not have any influence on firm value; there should be a proper balance between men and women on the companies' boards. They further advised the companies to have a pool of sufficiently qualified women to fill boardroom positions as required by the government legislations. To fulfill the increasing demand for competent women to serve on company boards requires that they have access to educational opportunities and the required skills to compete with male counterparts.

Some studies, for example, Adams and Ferreira (2009), Ahern and Dittmar (2012), and Bøhren and Staubo (2014) find a negative relationship between gender diversity and firm performance. Adams and Ferreira (2009) report an average negative effect of gender diversity on firm performance of S&P 500, S&P MidCap and S&P SmallCap companies. Although female directors on boards have a significant impact on board behaviours, such as better attendance of directors, the overall impact on firm performance is negative. They further argue that the mandatory gender quotas on top management and boards of directors also adversely affect the financial performance of well-governed firms. Ahern and Dittmar (2012) examine the impact of the mandatory quota system for gender balance that requires 40 per cent of each gender in the board of directors of Norwegian companies. Their paper finds that from the passage of a gender balance law (GBL) in 2003, listed companies in Norway suffered a substantial drop in stock price and a massive decline in Tobin's Q. The government's strict constraint to listed companies in the selection of a board of directors results in economically significant declines in firm value and operating performance. Bøhren and Staubo (2014) have a similar view that mandatory provision for optimal gender inclusion may produce firms with inefficient organizational structures or inefficient boards. A mandatory quota system in boardrooms shrinks in the pool of talent for competent directors and leads to younger, less experienced, and less knowledgeable boards of directors, increases in leverage, unnecessary acquisitions, and deteriorations in

performance. They find GBL in Norway costly to firms in general, and as a result, 51 per cent of firms chose to be de-listed as a response to the regulatory shocks.

Similarly, a large stream of studies such as Haslam et al. (2010), Adams et al. (2009), Rose (2007), Ye et al. (2010), Kroc-Kakabadse et al. (1998), find no significant differences from firms with female and male top executives. Haslam et al. (2010) examine the relationship between the presence of women on the boards of FTSE100 companies and different measures of firm performance. They find no evidence of a relationship between women's presence on the boards and accounting performance (ROA and ROE) and report a negative relationship with market returns (Tobin's Q). Ross (2007), in a sample of Danish firms, find no significant association between female board representation and firm performance (Tobin's Q). Based on the Cranfield survey study of the NHS Trust (UK) and APS (Australian Public Service) to explore the nature of the leadership philosophies adopted by men and women in senior roles and their impact on their respective organizations, Kroc-Kakabadse et al. (1998) find that gender as a non-significant demographic factor in determining leadership perspectives and performance. Organizational demographical factors other than genders, such as job and organizational tenure and the age of individuals, were identified as considerably influential factors in shaping the philosophy, attitudes and behaviours in organizations. A similar notion is presented by Ye et al. (2010) after examining the relationship between gender and earnings quality in a large sample of Chinese listed firms, looking at the genders of the Chair of the Board, the CEO gender and the CFO. They contend that the top executive gender is not associated with earnings quality. As earnings quality is vital for market efficiency, they suggest that for firms in an emerging market such as China gender diversity has no influence. Other sources of board heterogeneity, such as directors' functional background, education, tenure, and age, are more influential than gender in enhancing CG and performance.

This discussion reveals that the existing literature on boardroom gender diversity and its impact on CG and firm performance around the world are struggling to justify the economic perspective of increasing gender diversity. Many companies around the world

have been appointing women directors as tokenism to complying with a mandatory quota set by the laws (see Bøhren and Staubo, 2014; Ahern and Dittmar, 2012).

A few academic studies are found on gender diversity in Indian corporate sectors, for example, Handa and Singh (2015), Haynes and Ghosh (2012), Budhwar et al. (2005), and Haq (2013). However, none of these studies has examined the boardroom gender diversity linking with firm performance. Handa and Singh (2015) attempt to examine the influence of women directors on the underpricing phenomenon of IPO pricing and returns of 127 IPO firms. Their paper reports that the proportion of women directors has no significant impact on raw returns and market-adjusted returns. Their paper argues that gender diversity on corporate boards is not material to the perceptions of investors in buying decisions of firms' shares. Haynes and Ghosh (2012) highlight the challenges from the increased participation of urban women, who, by their demographic characteristics, represent diversity status in Indian enterprises. Urban women have progressed from the role of mother/wife to that of a professional; however, deeply rooted patriarchal culture, termed as gender stereotypes or glass ceiling and maternal wall, in Indian enterprises, hinders their career progression. Their paper further suggests to business enterprises to develop formal mentoring programs for female professionals as a first step to break the glass ceiling and navigate the maternal wall.

Budhwar et al. (2005), in a review paper, highlight the dynamics of developments in the status of Indian women executives. They discussed the main aspects of the historical, socio-cultural, and economic factors<sup>28</sup> influencing women executives, issues concerning gender-

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<sup>28</sup> Historically, roles in Indian society were based on gender and women were far from having equality with men. Women were perceived as soft, humble, and suitable for internal household affairs, with men perceived as physically active, assertive, and suitable for tough jobs, so they used to work outside to provide economical maintenance to households. Socio-cultural factors included inhibitions acquired by women from childhood, nurtured by parents, and reinforced during their socialization. Economic factors include lower and medium-class economic strata creating barriers for women's access to better education and skill development (Budhwar et al., 2005).

based stereotypes, the main barriers to women's progression to top managerial positions, and the impact of developments in information technology on women managers.

Some studies are found on the issue of workplace gender diversity or gender inclusion or gender balance, but none has examined the boardroom gender diversity of listed companies. Gender issues in India, as compared to other developed and emerging countries and contexts, are unique and complicated due to its religious and cultural diversity (Cooke and Saini, 2010) and to some extent are mandated by the law for minimum female representation. According to Haq (2013), in India, women face challenges due to the intersectionality of gender and other forms of identities in their personal and professional lives. Women are not only marginalized in education and healthcare but also compromised in their personal and professional development because they are undervalued, underemployed and under-rewarded. This scenario is also replicated on the Indian corporate boards. Corporate boards are not gender-balanced, and most companies are appointing women directors in the minimum numbers required by the law. According to Torchia et al. (2011), and Elstad and Ladegard (2012), one or two women (a few tokens) on boards of directors are unable to make any contributions as they will be categorized, stereotyped and ignored by the majority of male directors. However, to date, it is not known about the effects of boardroom gender diversity on firm performance of emerging economies, especially in India. This study makes contributions by empirically testing the effect of boardroom gender diversity on firm performance. Hence the following null hypothesis:

*Hypothesis 9: Boardroom gender diversity is not associated with firm performance in India.*

The above review of the literature shows that existing literature on characteristics of the board of directors and firm performance offer evidence only from relatively more matured and developed countries where internal CG has already been seen as a critical mechanism for protecting the interests of shareholders and other stakeholders. The discussion also reveals that a limited number of scholarly researches are available on boards'

characteristics and firm performance in India and they demonstrate no consensus on the economic impacts of board characteristics such as board leadership style, size, independence, and busyness. Other important board characteristics, such as directors' tenure, age, ownership, remuneration, and attendance in board meetings of listed companies in India, have not been examined yet.

## 4.5. Data and methodology

### 4.5.1. Data

Here is a table of information about the sample of large companies, from diverse sectors of Indian economy, listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

**Table 4. 2: Number and percentage of firms by industry classification (2011-2015)**

| Sector                  | Number and percentage selected |       |      |       |      |       |      |       |      |       |
|-------------------------|--------------------------------|-------|------|-------|------|-------|------|-------|------|-------|
|                         | 2011                           | %     | 2012 | %     | 2013 | %     | 2014 | %     | 2015 | %     |
| Pharm. & Biotech.       | 16                             | 10.32 | 17   | 11.41 | 15   | 9.93  | 19   | 12.75 | 19   | 12.75 |
| Personal Goods          | 14                             | 9.03  | 12   | 8.05  | 12   | 7.95  | 11   | 7.38  | 10   | 6.71  |
| Electricity             | 14                             | 9.03  | 14   | 9.40  | 15   | 9.93  | 13   | 8.72  | 14   | 9.40  |
| Construction/Material   | 14                             | 9.03  | 14   | 9.40  | 11   | 7.28  | 13   | 8.72  | 9    | 6.04  |
| Oil & Gas               | 11                             | 7.10  | 10   | 6.71  | 10   | 6.62  | 10   | 6.71  | 10   | 6.71  |
| Ind. Metals & Mining    | 15                             | 9.68  | 14   | 9.40  | 13   | 8.61  | 10   | 6.71  | 10   | 6.71  |
| Industrial Engineering  | 10                             | 6.45  | 9    | 6.04  | 9    | 5.96  | 10   | 6.71  | 8    | 5.37  |
| Automobiles & Parts     | 8                              | 5.16  | 8    | 5.37  | 9    | 5.96  | 10   | 6.71  | 10   | 6.71  |
| Software & Computer     | 7                              | 4.52  | 8    | 5.37  | 10   | 6.62  | 9    | 6.04  | 9    | 6.04  |
| Chemicals               | 7                              | 4.52  | 6    | 4.03  | 6    | 3.97  | 7    | 4.70  | 7    | 4.70  |
| Food Producers          | 5                              | 3.23  | 5    | 3.36  | 4    | 2.65  | 5    | 3.36  | 4    | 2.68  |
| Telecom. & Media        | 8                              | 4.52  | 8    | 5.37  | 10   | 6.62  | 8    | 5.37  | 9    | 6.04  |
| Electronic & Electrical | 3                              | 1.94  | 5    | 3.36  | 5    | 3.31  | 5    | 3.36  | 5    | 3.36  |
| Other                   | 23                             | 15.48 | 19   | 12.75 | 22   | 14.57 | 19   | 13.42 | 25   | 16.78 |
| Total                   | 155                            | 100   | 149  | 100   | 151  | 100   | 149  | 100   | 149  | 100   |

Financial information was obtained from Datastream for a sample of companies with large market value capitalization (MVC) from 14 industry classes over five years. Other board and CEO related information were compiled manually from multiple sources, as described in Table 4.3, below. Banks, and finance and insurance companies were excluded because of the special and intense regulatory environment in which they operate. As suggested by

Vafeas and Theodorou (1998), regulation disguises efficiency of firms, potentially reducing the importance of governance mechanisms.

**Table 4. 3: Sources of board characteristics and firm performance data**

| <b>Data</b>                                                                                                                                                                                                                                                                  | <b>Source</b>                                                  |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------|
| List of companies, market value capitalization, ROA, ROE, data to calculate Tobin's Q, liquidity and leverage                                                                                                                                                                | Datastream                                                     |
| No. of directors, CEO and Directors' age, directors' tenure, no. of independent directors, no. of directorships of directors, no. of female directors                                                                                                                        | BoardEx                                                        |
| Companies' annual reports, family shareholding, institutional investors' shareholding, directors' shareholding, total equity shares outstanding                                                                                                                              | <a href="http://www.moneycontrol.com">www.moneycontrol.com</a> |
| No. of board meetings, directors' attendance, CEO and directors' remuneration, no. of blockholders (holding >5% equity shares), total shares held by blockholders, female directors on board committees, directors' shareholding, companies' group affiliation, company type | Annual reports                                                 |
| For missing data and other relevant information                                                                                                                                                                                                                              | Websites of the companies, yahoo finance India,                |

In Datastream, the market value capitalization (MVC) is calculated as the market price of equity shares multiplied by the number of equity shares outstanding at the end of the fiscal year which is displayed in millions of units of the local currency, i.e. INR<sup>29</sup>. I use MVC for each year to arrange the companies in descending order from the highest MVC down to 200<sup>th</sup> highest MVC of the companies listed on BSE and NSE. Although my initial sample comprised the 200 largest companies, I had to remove firms from the sample where I could not find the required data for either board characteristics or financial performance. Finally, I obtained the sample size of 149 to 153 largest Indian companies in five years.

<sup>29</sup>My sample firms bear 51% of total MVC in 2011, 84% of total MVC in 2012, 70% of total MVC in 2013, 88% of total MVC in 2014, and 66% of total MVC in 2015 provided by DataStream.

## 4.5.2. Variables

### 4.5.2.1. Board characteristics (Independent variables)

This study considers the following board-related variables that were collected from BoardEx, the CNBC *moneycontrol.com* website, and from the annual reports of the companies:

**Board size (BoDSize):** Extant evidence on the benefits of having a larger or smaller board is inconclusive. There is a regulatory push in India to limit board size<sup>30</sup> intending to stop the listing companies from appointing a large number of directors. Following Goodstein et al. (1994), and Chaganti et al. (1985), the total number of directors on each board is taken as a measure of its size.

**Board independence (DirInd):** Board independence is measured as the proportion of directors who are unaffiliated or have no direct economic interests with firms. They are neither employee nor have any other identifiable relationship with the firm and are independent of management. In India, board independence depends on whether the board chairman is a non-executive director or an executive or a promoter director<sup>31</sup>. The proportion is calculated as the number of independent directors divided by the total number of directors (Beasley and Petroni, 2001; Kang et al., 2007).

**Directors' age (DirAge):** Age is one of the most observable diversity issues related to the background of directors (Kang et al., 2007). The CG codes in India require a director's age to be between 21 and 70<sup>32</sup>. I use the average age of directors on a board as a proxy for their business experience, which is calculated as the sum of the ages of all directors divided by the total number directors (Anderson et al., 2004).

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<sup>30</sup> The Companies Act 2013[149: 1(a) & (b)] requires listed companies to have 3 - 15 directors.

<sup>31</sup> See Clause 49 of the Equity Listing Agreement [II: A(1) & (2)]

<sup>32</sup> The Companies Act 2013 [196: 3(a)]

**Directors' tenure (DirTen):** This is the length of time directors serve in a board. It may affect the board's effectiveness in monitoring management and reflects the directors' company-specific knowledge and experience (Kesner, 1988; Bilimoria and Piderit, 1994), measured as the sum of the number of years that the directors serve on the board divided by the number of directors (Kesner, 1988; Kosnik, 1990; Anderson et al., 2004).

**Directors' remuneration:** In India, directors can be classified as executive, non-executive, or independent. The CG codes lay down separate guidelines for remuneration to EDs, NEDs, and IDs<sup>33</sup>.

- **Executive directors' remuneration (EDirRem):** This includes several components as incentives, such as cash salary, allowances, and performance-related elements. It is calculated as a ratio of the remuneration paid to executive and promoter directors to total assets.
- **Non-executive directors' remuneration (NEDirRem):** Non-executive and independent directors are paid much less than executive directors. They receive sitting fees based on the number of meetings attended. Some companies pay them commissions based on the company's net worth or turnover. I calculate *NEDirRem* as the ratio of the total remuneration paid to non-executive and non-promoter directors to total assets.

**CEO duality (CEODual):** The Corporate Governance Voluntary Guidelines 2009 recommend companies to have separate individuals as their CEO and Chairman, to stop a single individual having unfettered decision-making power and promote a balance of power<sup>34</sup>. Board leadership or CEO-Chairman duality is a binary variable equal to 1 if the CEO is also the chairman of the board, and otherwise 0.

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<sup>33</sup> See Corporate Governance Voluntary Guidelines 2009 (Section C) and the Companies Act 2013 [197 (1-15)]

<sup>34</sup> See Corporate Governance Voluntary Guidelines 2009 (Section A.2) and the Companies Act 2013 [203(1)]

**Board busyness (BoDBusy):** The Indian CG code permits a director to take directorships in a total of twenty companies (maximum ten in listed companies)<sup>35</sup>. The code is flexible about this because of the dominance of family-owned conglomerates and group affiliation in India's corporate sector. The average number of directorships held by a board of directors is taken as a proxy for that board's busyness (Jiraporn et al., 2009).

**Board meetings (BoDMeet):** Every listed company in India is required to hold a minimum of four board meetings each year<sup>36</sup>. Frequency of board meetings each year is taken as one of the proxies for board activities. Board meetings give directors access to information, increase their participation in decision-making processes, help in building a sense of shared responsibility, and motivate them to perform monitoring and advisory roles effectively (Hahn and Lasfer, 2016).

**Board attendance (BoDAttend):** Physical attendance of directors provides them with opportunities for interacting, advising, and formulating strategies, which may affect the firm performance. It is used as a proxy to measure supervisory quality and resource sharing activities of the board. The directors' attendance may be affected by their busyness as Indian directors are allowed to take multiple directorships of other companies. The average percentage of directors' attendance in companies' board meetings is calculated.

**Percentage of women directors (BoDGD):** It is argued that a greater proportion of women directors on board may bring heterogeneity in values, beliefs, and attitudes which may broaden the range of perspectives in the decision-making process (OECD, 2012), stimulate critical thinking and creativity (Lee and Farth, 2004), and improve firm performance. Following the approach of Campbell and Minguez-Vera (2008), and Reguera-Alvarado et al. (2017), boardroom gender diversity (*BoDGD*) is computed as the percentage of women among the board members.

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<sup>35</sup> See the Companies Act 2013 [165 (1)]

<sup>36</sup> See Clause 49 of the Listing Agreement and the Companies Act 2013 [173(1)]

#### 4.5.2.2. Control variables

**Firm size (*FirmSize*):** Because of the presence of economies of scale, firm size affects performance (Wing and Yiu, 1997). So, I included firm size as a control variable in my regression models. A numerical variable '*FirmSize*' is calculated as the natural logarithm of the book value of the total assets of the firm. A similar approach was used in previous empirical studies, such as Cornett et al. (2007), Bhagat and Bolton (2013), and Lin and Fu (2017).

**Leverage:** The use of leverage in capital structure may lower agency costs and affect firm performance by disciplining and encouraging managers to perform in the best interests of shareholders rather than indulging in discretionary behaviour (Jensen, 1986; Harris and Raviv, 1991). In contrast, Modigliani and Miller (1958) view that, in a perfect capital market free of taxes, transaction costs and other frictions, the capital structure is irrelevant in determining firm value. But, the Indian capital market is not perfect and not free of taxes and costs. Hence, I take leverage as a controlling variable that affects firm performance. I calculate leverage as the total debt to total capital (Maury, 2006; Bhagat and Bolton, 2013).

**Year effects:** Time-varying factors may affect CG efficiency and firm performance. Year effect is taken as a control variable while setting up the panel data.

**Firm-specific effect:** In any sample of listed companies, firm performance is driven, primarily, by industry or firm factors, i.e. some firms may be dominant value creators (leaders), and some may be destroyers (losers) (Hawawini et al., 2003). Firm-specific properties may determine their competitive advantages, CG, and firm performance, so the firm-specific effect is taken as a control variable while setting up the panel data.

#### 4.5.2.3. Performance variables (Dependent variables)

Three different performance variables are used: one market-based performance variable (as measured by Tobin's Q) and two accounting-based performance variables (as measured by return on assets (ROA) and return on equity (ROE)).

**Tobin's Q:** Tobin's Q, is a market-based measure of performance (Adams and Ferreira, 2009), assumes that the replacement values of a firm's assets, i.e. plants, equipment, inventories, etc., are equal to their book values. Further, Tobin's Q discounts and factors all parameters affecting firm performance (Kumar and Singh, 2012). It is a ratio of a firm's market value to replacement costs of its assets. The firm's market value equals the total value of assets minus the book value of equity, plus the market value of equity (Adams and Ferreira, 2009; Masulis and Mobbs, 2014). This stock-based measure is useful for examining whether minority shareholders account for the potential costs and benefits of ownership structure (Fan et al., 2012). Tobin's Q is considered as the most reliable measure of firm performance in the emerging economies where the accounting standards are not robust (Singh et al., 2018).

$$Tobin's\ Q = \frac{Total\ Assets - BV\ of\ Equity + MV\ of\ Equity}{Total\ Assets}$$

MV of equity is the product of a firm's market price per share and the number of common stock outstanding.

**Return on equity (ROE):** Return on equity is calculated thus:

$$ROE = \frac{Net\ Income\ After\ Tax - Preferred\ Dividend}{Average\ of\ Last\ Year's\ \&\ Current\ Year's\ Common\ Equity} \times 100$$

**Return on assets (ROA):** The return on assets is a measure of the success of a firm in using assets to generate earnings independent of the financing of those assets (Selling and Stickney, 1989). The ROA is calculated as:

$$ROA = \frac{[Net\ Income\ After\ Tax + (Interest\ on\ Debt - Interest\ Capitalized)\ (1 - T)]}{Average\ of\ Last\ Year's\ \&\ Current\ Year's\ Assets} \times 100$$

### 4.5.3. The model

The following equation captures the relationship between board characteristics and firm performance.

$$y_{it} = a + \beta x_{it} + \varepsilon_{it} \dots\dots\dots(1)$$

Where,  $y_{it}$  = performance variables (i.e. Tobin's Q, ROA and ROE);  $x_{it}$  = independent variables (i.e. BoDSize, DirInd, DirAge, DirTen, NEDirRem, BoDBusy, CEODual, BoDMeet, BoDAttend, BoDGD, Firm Size, and Leverage);  $\beta$  = regression coefficients of independent variables; and  $\varepsilon_{it}$  = residual (error term).

This paper uses panel data analysis which is an efficient tool for a mixture of time series and cross-sectional data. The panel data structure allows one to take into account the unobservable heterogeneity and endogeneity (De Andres and Vallelado, 2008), a situation of having a correlation between the explanatory variables and the error term in a regression, which commonly arises in empirical research in CG (Wintoki et al., 2012; Abdallah et al., 2015; Gippel et al., 2015). Endogeneity may exist due to the omission of explanatory variables (omitted variable bias) or by the dependent variable being influenced by one or several explanatory variables (simultaneous endogeneity) or by the past realizations of the dependent variables (dynamic endogeneity) (Abdallah et al., 2015; Wintoki et al., 2012). It is difficult to determine whether the causation is reversed (reverse causality e.g., performance drives governance) or due to an unobservable factor, which also affects performance (Wintoki et al., 2012). These issues cannot be addressed by ordinary least square (OLS) estimation as it does not account for the omitted variable inconsistency or omitted variable bias (Knyazeva et al., 2013). Traditional fixed-effects estimation, a class of regression method, makes it possible to control the omitted variable inconsistency and simultaneous endogeneity (Allison, 2009); however it ignores the dynamic nature of governance/performance relation that yields inconsistent estimates (Wintoki et al., 2012). A difficulty arises with the fixed effects model in the context of a dynamic panel data particularly in "small  $T$ , large  $N$ " panels, meaning few periods and many individuals;

independent variables that are not strictly exogenous, meaning they are correlated with past and possibly current realization of the error (Roodman, 2009). The panel dataset has time period  $T=5$  years, and number of observations  $N=753$ .

According to Wintoki et al. (2012), the application of system generalized method-of-moments (system GMM) estimations seems appropriate for the panel dataset which allows for controlling the potential sources of endogeneity which are inherent in the performance-governance relationship. Hence, system GMM estimator is applied with fully accounting for unobservable, simultaneous and dynamic endogeneity i.e., *performance=f(past performance, board structure, board characteristics, fixed effects)*. “The system GMM model enables to estimate the governance/performance relation while including both past performance and fixed-effects to account for the dynamic aspects of the governance/performance relation and time-invariant unobservable heterogeneity, respectively” (Winstoki et al., 2012: p596). It does not rely on external exogenous instruments, but rather it depends on its internal instruments contained within the panel itself based upon lagged values of the explanatory variables included in the regression equation and corrects for above mentioned three types of endogeneity (O’Connor and Rafferty, 2012; Wintoki et al., 2012).

Here is the equation for a fixed effect regression model:

$$y_{it} = a + \beta x_{it} + \eta_i + \varepsilon_{it} \dots\dots\dots(2)$$

Where,  $y_{it}$  = performance variables (i.e. Tobin’s Q, ROA, and ROE);  $x_{it}$  = independent variables (i.e. BodSize, DirInd, DirAge, DirTen, NEDirRem, BoDBusy, CEODual, BodMeet, BodAttend, BodGD, Firm Size, and Leverage);  $\beta$  = regression coefficients of independent variables;  $\eta_i$  = fixed effects; and  $\varepsilon_{it}$  = residual (error term).

To obtain consistent and unbiased estimates, the relation between board characteristics and firm performance is estimated using a system GMM model as suggested by Arellano and Bond (1991), the dependent variable  $y_{it}$  is generated from a model below:

$$y_{it} = \alpha y_{i(t-1)} + \beta x_{it} + \eta_i + \nu_{it}, \quad (i = 1, \dots, N; t = 1, \dots, T + 10) \dots\dots\dots(3)$$

Where,  $y_{it}$  = performance variables (i.e. Tobin's Q, ROA, and ROE);  $\beta$  = regression coefficients of independent variables;  $\eta_i$  = unobserved fixed effects;  $\nu_{it}$  = residual (error term); and  $T + 10$  implies that the first 10 cross-sections are discarded so that the actual sample contains  $NT$  observations.

For the estimation of  $x_{it}$ , the following generating equation is considered:

$x_{it} = \rho x_{i(t-1)} + \varepsilon_{it}$ ,      Where,  $x_{i(t-1)}$  = lag of independent variables at  $(t - 1)$  (i.e. all the independent variables in GMM regression model have dynamic effect of past year performance.)

## 4.6. Empirical results

### 4.6.1 Descriptive statistics

Descriptive statistics of dependent, independent and control variables, used in my models, are summarized in Table 4.4.

**Table 4. 4: Descriptive statistics**

| Variables    | Units of measurement | N   | Minimum  | Maximum    | Mean      | Std. Dev. |
|--------------|----------------------|-----|----------|------------|-----------|-----------|
| MVC          | Million Rs           | 753 | 24704.52 | 5010912.00 | 356153.67 | 565178.00 |
| Tobin's Q    | Ratio                | 753 | 0.96     | 10.05      | 3.28      | 2.59      |
| ROE          | Percent              | 753 | 3.51     | 57.61      | 21.59     | 13.75     |
| ROA          | Percent              | 753 | 1.76     | 26.81      | 11.02     | 7.06      |
| BoDSize      | Number of            | 753 | 4        | 20         | 10.48     | 2.91      |
| DirIndNo     | Number of            | 753 | 0        | 11         | 5.25      | 1.88      |
| DirInd       | Percent              | 753 | 0.00     | 85.71      | 50.07     | 12.11     |
| DirAge (yrs) | Years                | 753 | 45.50    | 75.67      | 60.18     | 4.30      |
| DirTen (yrs) | Years                | 753 | 0.00     | 29.01      | 5.65      | 3.53      |
| NEDirRem     | Ratio                | 753 | 0.00     | 0.0085994  | 0.0001467 | 0.0004775 |
| EDirRem      | Ratio                | 753 | 0.00     | 0.0449     | 0.0019683 | 0.0041028 |
| BoDBusy      | Number of            | 753 | 1.30     | 21.25      | 7.99      | 3.96      |
| BoDMeet      | Number of            | 753 | 2        | 21         | 6.42      | 2.63      |
| BoDAttend    | Percent              | 753 | 45.92    | 100        | 84.35     | 9.24      |
| BoDGD        | Percent              | 753 | 0.00     | 33.33      | 7.41      | 7.52      |
| TA           | Million Rs           | 753 | 1426.70  | 5044860.00 | 332957.20 | 560685.87 |
| Firm Size    | Natural log          | 753 | 21.08    | 29.25      | 25.52     | 1.47      |
| Leverage     | Percent              | 753 | 0.16     | 76.12      | 30.07     | 25.71     |

MVC = Market value capitalization in million Rs; Q = Tobin's Q; ROE = Return on Equity; ROA = Return on Assets; BoDSize = Board size measured as number of board of directors; DirIndNo = Number of independent directors; DirInd = Percentage of independent directors; DirAge= Average age of directors; DirTen = Average tenure of directors; NEDirRem = Ratio of non-executive and non-promoter directors' remuneration to total assets; EDirRem= Ratio of executive and promoter directors' remuneration to total assets; BoDBusy = Average no. of directorship of directors; BoDMeet = Number of board meetings in a year; BoDAttend = Average attendance of directors; BoDGD = boardroom gender diversity (% of total women on boards); TA = Total assets expressed in million Rs.; Firm Size = Firm size measured on natural log of total assets; Leverage = Ratio of total debt/ total equity capital; Tobin's Q, ROA, ROE and Leverage are winsorized at p=0.05 to reduce the effect of potential outliers.

The board size of the sample firms ranges from minimum 4 to maximum 20 with an average of 10.48. This is the larger than the average board size of 8.02 reported by Jameson et al. (2014), 8.37 reported by Singh and Gaur (2009), and 9.56 reported by Jackling and

Johl (2009) for Indian firms, and similar to large US firms i.e. 10.4 and 10.54 as reported by Coles et al. (2008), and Jiraporn et al. (2009), respectively. Indian companies are making progress in maintaining board independence as required by the Companies Act 2013. The proportion of independent directors is 50.07 per cent on average. This is the same as reported by Jameson et al. (2014), slightly higher (48 per cent) than Jackling and Johl (2009), but it is smaller than large US firms, i.e. 78 per cent reported by Coles et al. (2008) and 65.7 per cent reported by Linck et al. (2008). The directors' average age of 60.18 years implies that large Indian firms have more mature directors on their boards than reported by Jameson et al. (2014) i.e. the average age of 58.22 years. The average tenure of the board of directors in their current role is 5.65 years. Directors' remuneration is calculated as the total remuneration paid to independent and non-executive directors as *NEDirRem* and the total remuneration paid to the executive and promoter directors as *EDirRem*.

In terms of directors' busyness, the average directorship held is 7.99 with a standard deviation of 3.96. These figures are very higher than those by Jameson et al. (2014), i.e. average directorship of  $1.99 \pm 1.05$ . Between 2 and 21 meetings per year were held in the sample companies: their average of 6.42 is almost equal to the 6.32 reported by Jackling and Johl (2009) and less than the 7.15 in US firms reported by Jiraporn et al. (2009). The average attendance of directors in the board meetings is 84.35 per cent ranging from 45.92 per cent to 100 per cent, with standard deviation of 9.24. In terms of CEO duality, 30 per cent of sample firms have CEOs who are also the Chairmen.

Table 4.4 also shows that Indian companies are less gender-inclusive, with 7.41 per cent board seats, on average, held by women directors. The number of companies with at least one woman director is rapidly increasing: 46.45, 51.01, 52.32, 58.39, and 85.91 per cents in 2011, 2012, 2013, 2014, and 2015, respectively. However, the total percentage of women directors has not increased as much: 5.81, 6.70, 6.98, 7.63, and 10.96 in 2011, 2012, 2013, 2014, and 2015, respectively (see Table 4.1). Evidently companies are merely obeying the law.

There is a considerable variation in firm sizes, as measured by total book value of assets, ranging from Rs. 1,426.70 million to Rs. 5,044,860 million. The average size and standard deviation are Rs. 332,957.20 million and Rs. 560,685.87 million, respectively.

## 4.6.2 Correlation and regression results

Correlations coefficients between the variables are either low or moderate. This is confirmed via the variance-inflation factor (VIF)<sup>37</sup> test, presented in Table 4.5, which suggests that there is no significant multicollinearity among the variables.

**Table 4. 5: Variance-inflation factors**

| Variable  | VIF  |
|-----------|------|
| BoDSize   | 1.23 |
| DirInd    | 1.27 |
| BoDBusy   | 1.49 |
| DirTen    | 1.70 |
| DirAge    | 1.62 |
| NEDirRem  | 1.11 |
| EDirRem   | 1.35 |
| CEODual   | 1.26 |
| BoDMeet   | 1.47 |
| BoDAttend | 1.19 |
| BoDGD     | 1.07 |
| Firm Size | 2.03 |
| Leverage  | 1.38 |

BoDSize = Board size measured as number of board of directors; DirInd = % of independent directors; BoDBusy = Average no. of directorship of directors; DirTen = Average tenure of directors; DirAge = Average age of directors; NEDirRem = Ratio of non-executive and non-promoter directors' remuneration to total assets; EDirRem= Ratio of executive and promoter directors' remuneration to total assets; CEODual = CEO duality proxied by 1 if the CEO also the Chairman of the firm and otherwise 0; BoDMeet = No. of board meetings in a year; BoDAttend = Average attendance of directors; BoDGD = boardroom gender diversity (% of total women on boards); Firm Size = Firm size, as natural log of total assets; Leverage = Total debt/total equity capital.

<sup>37</sup> VIF is computed for the confirmation of non-multicollinearity among the independent variables. The commonly accepted threshold VIF for multicollinearity is more than equal to 10 (Kayhan et al. 2010; Satıcı & Uysal, 2015).

Correlation coefficients among the variables of the model in Table 4.6 show that firm performance variables (Tobin's Q, ROA, and ROE) are positively correlated with board independence, directors' attendance, and directors' tenure, but negatively correlated with board size, directors' busyness, board meeting frequencies, CEO duality, and directors' age. A positive correlation is found for Tobin's Q and ROA and a negative correlation for ROE with boardroom gender diversity. Similarly, directors' age is correlated positively with ROE and negatively with Tobin's Q and ROA.

**Table 4. 6: Correlation coefficients of board characteristics and firm performance**

| SN | Variables | 1      | 2      | 3      | 4      | 5      | 6      | 7      | 8      | 9      | 10     | 11     | 12     | 13     | 14     | 15    | 16    |
|----|-----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|-------|-------|
| 1  | Q         | 1.000  |        |        |        |        |        |        |        |        |        |        |        |        |        |       |       |
| 2  | ROA       | 0.683  | 1.000  |        |        |        |        |        |        |        |        |        |        |        |        |       |       |
| 3  | ROE       | 0.568  | 0.774  | 1.000  |        |        |        |        |        |        |        |        |        |        |        |       |       |
| 4  | BoDSize   | -0.181 | -0.092 | -0.070 | 1.000  |        |        |        |        |        |        |        |        |        |        |       |       |
| 5  | DirInd    | 0.003  | 0.032  | 0.014  | 0.023  | 1.000  |        |        |        |        |        |        |        |        |        |       |       |
| 6  | NEDirRem  | 0.232  | 0.189  | 0.152  | -0.037 | 0.055  | 1.000  |        |        |        |        |        |        |        |        |       |       |
| 7  | EDirRem   | 0.370  | 0.397  | 0.258  | -0.130 | 0.057  | 0.200  | 1.000  |        |        |        |        |        |        |        |       |       |
| 8  | BoDBusy   | -0.017 | -0.099 | -0.018 | -0.033 | 0.368  | 0.032  | -0.008 | 1.000  |        |        |        |        |        |        |       |       |
| 9  | BoDMeet   | -0.186 | -0.151 | -0.071 | 0.190  | -0.257 | -0.101 | -0.176 | -0.341 | 1.000  |        |        |        |        |        |       |       |
| 10 | BoDAttend | 0.002  | 0.085  | 0.070  | -0.026 | 0.043  | 0.017  | 0.093  | -0.173 | -0.011 | 1.000  |        |        |        |        |       |       |
| 11 | DirTen    | 0.157  | 0.100  | 0.130  | -0.034 | 0.268  | 0.110  | 0.213  | 0.292  | -0.317 | -0.049 | 1.000  |        |        |        |       |       |
| 12 | DirAge    | -0.008 | -0.018 | 0.014  | 0.167  | 0.256  | -0.059 | -0.113 | 0.178  | -0.156 | 0.068  | 0.495  | 1.000  |        |        |       |       |
| 13 | CEODual   | -0.173 | -0.057 | -0.080 | 0.177  | -0.108 | -0.134 | -0.004 | -0.321 | 0.325  | 0.103  | -0.200 | -0.113 | 1.000  |        |       |       |
| 14 | BoDGD     | 0.071  | 0.045  | -0.031 | 0.073  | 0.105  | 0.001  | 0.023  | 0.085  | -0.036 | 0.061  | 0.022  | -0.084 | -0.016 | 1.000  |       |       |
| 15 | Firm Size | -0.634 | -0.444 | -0.365 | 0.352  | -0.010 | -0.253 | -0.406 | -0.045 | 0.358  | 0.197  | -0.211 | 0.144  | 0.200  | -0.010 | 1.000 |       |
| 16 | Leverage  | -0.511 | -0.600 | -0.267 | 0.107  | 0.030  | -0.149 | -0.266 | 0.172  | 0.114  | -0.019 | -0.006 | 0.095  | 0.049  | -0.117 | 0.451 | 1.000 |

Q = Tobin's Q (winsorized, 0.05); ROE = Return on Equity (winsorized, 0.05); ROA = Return on Assets (winsorized, 0.05); BoDSize = Board size measured as number of board of directors; DirInd = Percentage of independent directors; DirAge= Average age of directors; DirTen = Average tenure of directors; NEDirRem = Ratio of non-executive and non-promoter directors' remuneration on total assets; EDirRem= Ratio of executive and promoter directors' remuneration on total assets; BoDBusy = Average no. of directorship of directors; BoDMeet = Number of board meetings in a year; BoDAttend = Average attendance of directors; CEODual = CEO duality proxied by 1 if the CEO also the Chairman of the firm and otherwise 0; BoDGD = boardroom gender diversity (% of total women on boards); Firm Size = Firm size measured on natural log of total assets; Leverage = Ratio of total debt/ total equity capital (winsorized, 0.05).

**Table 4. 7: System GMM estimations for board characteristics and firm performance**

| Variables              | Q (coef/se)          | ROA (coef/se)         | ROE (coef/se)           |
|------------------------|----------------------|-----------------------|-------------------------|
| Tobin's $Q_{t-1}$      | 0.649***<br>(0.120)  |                       |                         |
| $ROA_{t-1}$            |                      | 0.489***<br>(0.182)   |                         |
| $ROE_{t-1}$            |                      |                       | 0.371***<br>(0.144)     |
| BoDSize                | -0.043<br>(0.093)    | -0.657<br>(0.479)     | 0.392<br>(0.765)        |
| DirInd                 | -0.046*<br>(0.024)   | -0.162*<br>(0.096)    | -0.188*<br>(0.110)      |
| BoDBusy                | -0.020<br>(0.098)    | -0.401<br>(0.544)     | -0.235<br>(0.768)       |
| DirTen                 | 0.237**<br>(0.118)   | 0.887*<br>(0.461)     | -2.747**<br>(1.263)     |
| DirAge                 | 0.091<br>(0.100)     | -0.693*<br>(0.411)    | 3.649**<br>(1.691)      |
| NEDirRem               | -87.329<br>(131.976) | 438.983<br>(2684.159) | 3217.311<br>(2,074.005) |
| EDirRem                | -2.187<br>(70.344)   | 128.813<br>(314.601)  | 17.965<br>(859.772)     |
| CEODual                | -1.113*<br>(0.666)   | 1.698<br>(1.833)      | 1.682<br>(18.004)       |
| BoDMeet                | 0.044<br>(0.148)     | 0.573<br>(0.472)      | 1.520<br>(1.049)        |
| BoDAttend              | 0.066<br>(0.048)     | 0.196<br>(0.203)      | -0.309<br>(0.453)       |
| BoDGD                  | 0.002<br>(0.030)     | -0.166*<br>(0.101)    | -0.357*<br>(0.205)      |
| Firm Size              | -0.647***<br>(0.236) | -2.286***<br>(0.879)  | -16.789***<br>(4.704)   |
| Leverage               | 0.002<br>(0.015)     | -0.076<br>(0.065)     | 0.240<br>(0.175)        |
| Number of observations | 544                  | 544                   | 544                     |
| Hansen Test p-value    | 0.130                | 0.874                 | 0.662                   |
| Wald Chi <sup>2</sup>  | 76.39                | 70.86                 | 34.05                   |
| AR(1)                  | 0.000                | 0.014                 | 0.022                   |
| AR(2)                  | 0.943                | 0.494                 | 0.879                   |
| Year Effect            | Yes                  | Yes                   | Yes                     |
| Firm Specific Effect   | Yes                  | Yes                   | Yes                     |

Q = Tobin's Q; Tobin's  $Q_{t-1}$  = One year lag of Q; ROE = Return on Equity;  $ROE_{t-1}$  = One year lag of ROE; ROA = Return on Assets;  $ROA_{t-1}$  = One year lag of ROA; BoDSize = Board size as number of board of directors; DirInd = Percentage of independent directors; DirAge = Average age of directors; DirTen = Average tenure of directors; NEDirRem = Ratio of non-executive and non-promoter directors' remuneration on total assets; EDirRem = Ratio of executive and promoter directors' remuneration on total assets; BoDBusy = Average no. of directorship of directors; BoDMeet = Number of board meetings in a year; BoDAttend = Average attendance of directors; CEODual = CEO duality proxied by 1 if the CEO also the Chairman and otherwise 0; BoDGD = Boardroom gender diversity (% of total women on boards); Firm Size = Firm size measured as natural log of total assets; Leverage = Ratio of total debt/ total equity capital. \*\*\*, \*\*, and \* = statistically significant at 0.01, 0.05, and 0.10, respectively. Standard errors are in parenthesis.

Table 4.7 reports the regression results of the system GMM of the Arellano-Bond dynamic panel data estimations for Tobin's Q, ROA, and ROE for the unbalanced pooled sample of large Indian companies. The second column of the table shows the regression coefficients of the one-step system GMM estimations for Tobin's Q as a dependent variable, and board characteristics and other control variables as explanatory variables. The model also uses a one year lag of Tobin's Q as one of the explanatory variables to capture whether there is a dynamic effect of last year's performance on current year's Tobin's Q. Also, one year lag of Tobin's Q is used as the internal predetermined variable and BoDSize, BoDBusy, BoDMeet, NEDirRem, EDirRem, CEODual, BoDMeet and Firm Size as internally available instrumental variables. Similarly, the third column of the table provides regression coefficients of the one-step system GMM estimation for ROA as the regressor. The model uses one year lag of ROA, board characteristics, and control variables as explanatory variables. Lag of ROA is used as predetermined variable and BoDSize, BoDBusy, BoDMeet, CEODual, BoDGD, and Firm Size as other internally available instrumental variables. Finally, the last column of the table shows regression coefficients of the one-step system GMM estimations for ROE using one year lag of ROE, board characteristics, and control variables as explanatory variables. ROE, leverage, and NEDirRem are used as predetermined variables and DirInd, BoDSize, BoDBusy, BoDMeet, EDirRem, and BoDGD as other internally available instrumental variables.

Firm performance measures, Tobin's Q, ROA, and ROE, have a negative and statistically significant relationship with board independence, proxied by DirInd, all significant at 0.10. The association of directors' tenure (DirTen) with Tobin's Q and ROA are positive and significant at 0.05 and 0.10, respectively, and with ROE, the association is negative and significant at 0.05. Directors age (DirAge) is positively associated with ROE, significant at 0.10, whereas it is negatively associated with ROA, significant at 0.10. The positive association between directors' age and Tobin's Q is statistically not significant. Board leadership style (CEODual) is negatively associated with Tobin's Q (significant at 0.10) but not related to other performance variables. Board gender diversity (BoDGD) is negatively related to accounting performance, ROA and ROE (both significant at 0.10 level of significance, respectively).

Similarly, firm size is negatively related to firm performance, Tobin's Q, ROA, and ROE, significant at 0.05, 0.05 and 0.01, respectively. The regression results reveal that all the performance variables have a positive and statistically significant relationship with the past performance of the firms (all significant at 0.01). Similarly, the one-step system GMM estimation shows that board size, busyness, meeting frequency, directors' remuneration, attendance in the board meetings, and leverage are unrelated to any form of firm performance.

### **Impact of rule-based approach of corporate governance on firm performance**

Until the issuance of Companies Act 2013, most of the CG rules in India were voluntary similar to the UK' comply or explain' approach. This approach is also known as the business approach or principle-based approach of CG. However, the Companies Act 2013 has incorporated most of the CG requirements as the hard law, mandatory to all listed companies, similar to the US SOX 2002, which is also known as rule-based approach.

The change in CG mechanisms from the principle-based approach to rule-based approach provides an exogenous shock that put several constraints on board characteristics in terms of appointing female directors, determining board size, leadership style, directors' independence, board activities and directors' age. In this section, I examine the impact of the rule-based approach in analysing the relationship of board characteristics on firm performance. For this purpose, I use year dummy variables assigning 0 for the data before the issuance of the Companies Act 2013 and 1 for the data after the issuance of the Act. Also, I use board characteristics variables interacted with year dummies which help to relate each variable with firm performance accounting for the impact of the Companies Act 2013. The explanatory variables, BoDSize, DirInd, BoDBusy, DirAge, CEODual and BoDGD are chosen because they are mandated by the Companies Act 2013 as the hard laws. These variables are multiplied by year dummy variable to create additional interactive dummy variables. A similar approach has been used by Ahern and Dittmar (2012) to examine the impact on firm value by the mandatory quota for female board representation in the Norwegian new gender-balanced law of 2003. Table 4.8 summarises the regression results showing the impact

of the rule-based approach of CG on firm performance in a sample of the largest companies in India.

**Table 4. 8: System GMM estimations for impacts of rule-based approach of CG on firm performance**

| Variables         | Q (coef/se)           | ROA (coef/se)        | ROE (coef/se)         |
|-------------------|-----------------------|----------------------|-----------------------|
| Tobin's $Q_{t-1}$ | 0.364**<br>(0.155)    |                      |                       |
| $ROA_{t-1}$       |                       | 0.633***<br>(0.096)  |                       |
| $ROE_{t-1}$       |                       |                      | 0.432**<br>(0.170)    |
| BoDSize           | 0.119<br>(0.147)      | 0.199<br>(0.249)     | -2.324<br>(1.889)     |
| Dirind            | -0.071*<br>(0.043)    | -0.109*<br>(0.064)   | -0.391*<br>(0.226)    |
| BoDbusy           | -0.047<br>(0.168)     | 0.080<br>(0.221)     | 0.233<br>(0.647)      |
| DirTen            | 0.083<br>(0.070)      | 0.413<br>(0.321)     | -0.320<br>(0.300)     |
| DirAge            | 0.097<br>(0.107)      | -0.440*<br>(0.241)   | 0.767*<br>(0.434)     |
| NEDirRem          | -153.481<br>(106.038) | 371.012<br>(716.896) | 154.148<br>(718.685)  |
| EDirRem           | -32.054<br>(37.154)   | 84.835<br>(168.104)  | -229.608<br>(489.101) |
| CEODual           | -1.059<br>(1.463)     | 0.524<br>(1.221)     | 4.193<br>(6.059)      |
| BoDMeet           | 0.174**<br>(0.079)    | 0.270<br>(0.297)     | 0.863<br>(0.891)      |
| BoDAttend         | 0.035**<br>(0.018)    | 0.151<br>(0.121)     | 0.393<br>(0.249)      |
| BoDGD             | -0.051<br>(0.060)     | -0.133*<br>(0.068)   | -0.180*<br>(0.105)    |
| FirmSize          | -1.628**<br>(0.715)   | -1.196**<br>(0.606)  | -2.018**<br>(0.978)   |
| Leverage          | -0.009<br>(0.033)     | -0.057*<br>(0.030)   | -0.045<br>(0.044)     |
| Year Dummy        | -2.610<br>(22.108)    | -5.852<br>(14.660)   | 42.240<br>(52.962)    |

|                        |                   |                   |                    |
|------------------------|-------------------|-------------------|--------------------|
| BoDSize × Year Dummy   | -0.050<br>(0.350) | -0.108<br>(0.189) | 2.918<br>(1.933)   |
| DirInd × Year Dummy    | 0.034<br>(0.073)  | 0.041<br>(0.055)  | 0.281<br>(0.377)   |
| BoDBusy × Year Dummy   | 0.136<br>(0.299)  | -0.127<br>(0.148) | 0.152<br>(1.187)   |
| DirAge × Year Dummy    | -0.002<br>(0.274) | 0.097<br>(0.278)  | -1.512<br>(1.030)  |
| CEODual × Year Dummy   | 1.862<br>(3.122)  | -0.175<br>(1.070) | -8.180<br>(10.631) |
| BoDGD × Year Dummy     | 0.079<br>(0.148)  | 0.031<br>(0.069)  | 0.458<br>(0.302)   |
| Number of observations | 544               | 544               | 544                |
| Hansen Test p-value    | 0.136             | 0.869             | 0.880              |
| Wald Chi <sup>2</sup>  | 344.11            | 319.71            | 203.08             |
| AR (1)                 | 0.144             | 0.120             | 0.050              |
| AR (2)                 | 0.933             | 0.228             | 0.056              |
| Year Effect            | Yes               | Yes               | Yes                |
| Firm Specific Effect   | Yes               | Yes               | Yes                |

Q = Tobin's Q; Tobin's  $Q_{t-1}$  = One year lag of Q; ROE = Return on Equity;  $ROE_{t-1}$  = One year lag of ROE; ROA = Return on Assets;  $ROA_{t-1}$  = One year lag of ROA; BoDSize = Board size as number of board of directors; DirInd = Percentage of independent directors; DirAge= Average age of directors; DirTen = Average tenure of directors; NEDirRem = Ratio of non-executive and non-promoter directors' remuneration on total assets; EDirRem= Ratio of executive and promoter directors' remuneration on total assets; BoDBusy = Average no. of directorship of directors; BoDMeet = Number of board meetings in a year; BoDAttend = Average attendance of directors; CEODual = CEO duality proxied by 1 if the CEO also the Chairman and otherwise 0; BoDGD = Boardroom gender diversity (% of total women on boards); Firm Size = Firm size measured as natural log of total assets; Leverage = Ratio of total debt/ total equity capital. Year 2013 is taken as the major event in shifting principle-based approach to rule-based approach. Year dummy is proxied by 1 if observations are after 2013, otherwise 0. Interactive dummies are calculated by multiplying explanatory variables by year dummy. \*\*\*, \*\*, and \* = statistically significant at 0.01, 0.05, and 0.10, respectively. Standard errors are in parentheses.

The regression coefficients on Table 4.8 show the impact on firm performance by the issuance of Companies Act 2013. A finding of any effect, positive or negative would be important evidence that mandatory CG laws affect firm performance. However, the result shows that the year dummy variable has statistically insignificant association with firm performance measures. Also all the integrative dummy variables have no significant association with any form of firm performance.

### 4.6.3 Robustness checks

Several robustness checks increase the level of confidence in capturing the impact of board characteristics on firm performance. First, I computed variance inflation factors (VIF) to confirm non-multicollinearity among the variables and found all the independent variables of the models are within the threshold level of acceptance, i.e. below 10. The highest and lowest VIFs are 2.03 and 1.07, respectively (see Table 4.5). Second, I performed Hansen tests for overriding effects. In the case of instrumental variables, Hansen Test legitimizes the instrumental variable sets at a 0.05 significant level (Blundell and Bond, 2000; Ghartey, 1998). In my models, all the p-values of the Hansen Test statistics are above 0.05, hence the instruments selections for the models are legitimized. Third, Wald  $\chi^2$  test statistics are computed to check the fit of the models and to ensure that the instruments are strong. All my models have Wald  $\chi^2$  with  $p = 0.000$ <sup>38</sup>, indicate that the variables create a statistically significant improvement in the fit of the models. Finally, the Arellano-Bond tests, AR(1) and AR(2) are performed to check whether there is a serial autocorrelation among the variables in my regression models and the test statistics show that the models have no second-order autocorrelation and hence their further modifications are not required. Meeting these tests indicates, the system GMM is an appropriate model specification for my study.

## 4.7 Discussion

In this sub-section, the relationship between board characteristics and firm performance is discussed. The discussion is based on the regression results of board characteristics (board leadership style, board independence, board size, directors' remuneration, directors' tenure, directors' age, board activities, and boardroom gender diversity) against firm performance measures (Tobin's Q, ROA, and ROE) (see Table 4.7).

**Board size and firm performance:** The test statistics show no significant association between board size and firm performance, so I accept hypothesis 1. My result does

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<sup>38</sup> Based on the p-value, I am able to reject the null hypothesis, indicating that the coefficients of the variables are not simultaneously equal to zero.

support neither the agency theory nor the resource-dependency theory of CG: neither larger boards bring more resources to firms, nor do smaller boards reduce or mitigate agency costs and contribute to the firm performance. My findings support Di Pietra et al. (2008) for Italian firms and McIntyre et al. (2007) for Canadian firms, whom both provide no evidence that board size has a substantial impact on firm performance. However, my findings contradict Larmou and Vafeas (2010), who document a positive association of board size with performance in a sample of US firms. Also, my findings differ from the negative relationship between board size and firm performance reported by Yermack (1996) for US firms, Eisenberg et al. (1998) for Finnish firms, Mak and Kusnadi (2005) for Singaporean and Malaysian firms, and Guest (2009) for a large sample of UK listed firms.

My findings do not corroborate with Jackling and Johl (2009), on a sample of top Indian companies listed on BSE, and Jameson et al. (2014), who report a positive impact of board size on performance for a large sample of firms listed on BSE. In contrast, Kumar and Singh (2013) show a negative relationship of board size with a firm value of 176 firms listed on BSE, India. My findings do not provide empirical support for the mandatory restriction on board size in India. To a certain extent, they buttress the arguments made by corporate houses and corporate reformers calling for no restrictions on board size.

***Board independence and firm performance:*** The empirical finding reveals a negative and significant association between board independence and all firm performance measures. This finding is contrary to hypothesis 2, that board independence is associated with firm performance, but the association is negative: more board independence is associated with decreased performance. It agrees with Sarkar and Sarkar (2009) and Jackling and Johl (2009) who report a negative relationship of board independence and firm performance for large companies in India, and also with Agrawal and Knoeber (1996) for large US firms.

On the other hand, a positive association between board independence and firm value was reported by Rosentein and Wyatt (1990) for US firms, Knyazeva et al. (2013) for S&P 1500 firms, Lefort and Urzua (2008) for Chilean firms, Bhagat and Bolton (2013)

for US firms, and Liu et al. (2015) for Chinese firms. Bhagat and Black (2002) report that US firms with more independent boards do not perform better than other firms. Similarly, this finding does not support Jameson et al. (2014), for a sample of Indian companies, where they report evidence that board independence is effective in mitigating adverse impacts of controlling shareholders on firm performance.

The regulatory mandate of the Companies Act 2013, the Corporate Governance Voluntary Guidelines 2009, and Clause 49 of the Listing Agreement for Indian companies, to maintain a minimum of one-third independent directors (if the chairman is non-executive), or at least 50 per cent independent directors (without non-executive chairman or non-executive chairman from promoter), is not effective in enhancing firm performance. Instead, a higher number of independent directors on board provides negative impacts on all forms of firm performance. Board independence does not solve either form of agency conflict (principal-principal or principal-agent conflict). Instead, this result supports the arguments of Finkelstein and D'Aveni (1994) and Davis et al. (1997) in favour of stewardship theory that having more insiders on the board of directors provides unified leadership and helps make decisions more prudent.

***Directors' remuneration and firm performance:*** The regression coefficients between various forms of firm performance and remuneration paid to both the independent and non-executive directors (NEDirRem), and executive and promoter directors (EDirRem) are not statistically significant. Based on this result, I accept hypothesis 3, that directors' remuneration is not related to firm performance. This finding does not support the agency theory or the resource-dependency theory. The remuneration paid to the independent and non-executive directors neither helps to solve agency problems nor brings valuable resources into companies. Independent and non-executive directors may be critical components of CG mechanisms (Malin et al., 2015) and active monitors, but such directors are paid lower remuneration for their roles (Adams and Ferreira, 2008; Goh and Gupta, 2016). Independent and non-executive directors are paid mainly for their observable efforts and their responsibilities within the board committees (e.g. sitting fees for the meeting they attend). Besides, some companies pay commission to their independent and non-executive directors but only a tiny fraction of the remuneration paid to their executive and promoter directors. Adams and Ferreira (2008)

for S&P 1500 firms find that directors respond positively to monetary incentives in the forms of higher meeting fees and commissions. Since these positions require more commitment and expertise from the directors, companies are required to provide them with appropriate incentive packages for their efforts.

My finding implies that either the payments to NEDs and IDs are minimal and not enough to motivate them for better performance or the argument of Fama and Jensen (1983) that candidates may be attracted to these positions for other than financial reasons. Similarly, this finding suggests that the remuneration paid to executive directors (EDs) is also not having any impact on firm performance. It shows that listed companies in India are not paying much attention in designing compensation packages of the board of directors. Most companies are family-owned, and the principal owners from the families directly or indirectly influence the pay packages of their executives (Sarkar et al., 2008). Primarily, directors in state-owned companies draw a comparatively lower amount of remuneration than in other companies with a mix of fewer varieties in their pay package.

***Directors' tenure and firm performance:*** The regression coefficients show that the board of directors' tenure (DirTen) is related to the firm performance, suggesting rejection of hypothesis 4. The regression coefficients, for directors' tenure versus Tobin's Q and ROA, are positive and statistically significant. It indicates that the market perceives long-serving directors as reliable, associated with greater experience, commitment, and competence, as they may have valuable knowledge about the firm and its business environment (Vafeas, 2003). My finding disagrees with Erickson et al. (2005), who find no significant relationship between directors' tenure and Tobin's Q for Canadian firms. Similarly, long-tenured directors are found effective in the utilization of the companies' assets, as shown by the positive and significant regression coefficients of ROA and directors' tenure.

The regression result shows a negative and significant relationship of directors' tenure with ROE suggesting that directors with the longer terms in the office may not exercise independent judgment in maximizing shareholders' returns (Sharma and Iselin, 2012). This result disagrees with Muth and Donaldson (1998), who find no association of

directors' tenure with ROA and ROE for a sample of Australian companies. My results argue in favour of stewardship theory, as the market views long-serving directors positively and, with the passage of more years in office, directors establish themselves as the stewards of the companies' property. These findings support the current CG code in India that, unlike the USA and UK, permits directors' longer terms in office. However, long-serving directors diminish shareholders' returns, as Katz and McIntosh (2014) argue that long-tenured directors are more entrenched, unduly defensive to management and blind to shareholders' concerns.

***Directors' age and firm performance:*** The regression result shows a mixed relationship between the board of directors' age (DirAge) and firm performance in India. I reject hypothesis 5 for an association between directors' average age and accounting performance measures, i.e. ROA and ROE. The relationship of directors' age with ROE is positive and statistically significant, implying that the board of directors' age matters for maximizing shareholders' returns. These results do not support the arguments of Ferris et al. (2003) for the Forbes 500 firms. They argue that older directors might pose a last-period risk to the firm by seeking to maximize their income by their retirement. Also, the arguments of Muth and Donaldson (1998), for Australian companies, that the conservatism of an older board would mean over-control of management risk-taking, which would reduce shareholder returns. However, the result shows a negative association with ROA, implying that older directors hurt firm performance by not optimizing assets use. They might have less focus on current employment and may be attracted for multiple directorships (Ferris et al., 2003), and likely to suffer from communication barriers (due to the potential generation gap between old-age and young directors) leading to interpersonal frictions and conflicts in the boardroom (Talavera et al., 2018). Age may prevent the board from functioning effectively, ultimately resulting in inadequate monitoring and control of the firm resources.

In contrast, the board of directors' age shows no significant association with Tobin's Q, suggesting that directors' business experience and immediate economic interests have no discernible impact on firms' market performance. The market participants are indifferent to the age of a board of directors. This finding does not corroborate Mahadeo et al. (2012), who find a positive association between age diversity and firm

performance in Mauritius, nor Hafsi and Turgut (2013), who find an adverse effect of age diversity on the corporate social performance of S&P 500 firms. Similarly, the finding does not agree with the arguments made by the prior studies, such as Rhodes (1983), Houle (1990), and Bilimoria and Piderit (1994), that directors' age reflects, directors' overall business experience, background, and maturity in directing the business. The directors' age does not make significant contributions in enhancing firms' market performance, as indicated by the regression coefficient with insignificant test statistics value between directors' average age and Tobin's Q.

Due to the mixed results, it is difficult to articulate whether older or younger directors on board of directors improve organizational performance of listed companies in India. Hence, those corporate reformers and policymakers who have been calling for limiting directors' age should be advised that it would be better to leave companies free to decide the age limits of their directors.

***CEO duality and firm performance:*** CEO duality is about the board leadership style, i.e. whether the CEO-chairman roles separated or combined (CEODual) relate to firm performance. Based on the findings for Tobin's Q, I reject hypothesis 6, that the CEO duality is associated with firm performance (Tobin's Q). However, this association is negative. This finding does not agree with the findings of prior literature based on the samples of India's top companies, for example, Jackling and Johl (2009) who find no significant differences from CEO duality or non-duality on firm performance.

My finding for Tobin's Q supports agency theory that CEO duality increases the agency conflicts because of the concentration of decision and control roles on a single individual. From this perspective, this result agree with the US-based studies, for example, Rechner and Dalton (1991), Finkelstein and D'Aveni (1994), Yermack (1996), Iyengar and Zampelli (2009), and Duru et al. (2016), who report that the firms with CEO non-duality (i.e. separate individuals on CEO and Chairman roles) consistently outperform firms relying on CEO duality.

However, in contrast, the regression results for accounting performance (ROA and ROE) do not support either of the theories, i.e. stewardship or agency, because of no

significant association of CEO duality with ROA and ROE. This finding supports Daily and Dalton (1992; 1993; 1994a), Kang and Zardkoohi (2005), and Boyd et al. (2011) that there is no tangible impact of CEO duality affecting firm performance. They argue that there is no optimal board leadership model, and companies should select the most appropriate one, depending on their circumstances.

In India, the Corporate Governance Voluntary Guidelines 2009 and the Companies Act 2013 mandates listed companies with multiple businesses to have separate individuals for CEO and chairman positions and for other companies this provision is non-mandatory. Based on the empirical evidence, I can infer that the board leadership style alone is not a driving force for stronger CG and firm performance. “Good governance codes are often not mandated legal requirements but a set of norms, adherence to which is voluntary. They represent what public or private organizations consider as best practices and following them can bring a firm considerable legitimacy” (Yoshikawa and Rasheed, 2009: pp. 391). It would be better to leave companies free to have a particular leadership style and let them explain why that particular leadership style is appropriate for them.

***Board busyness and firm performance:*** No association is found between board busyness (multiple directorships of directors) and firm performance, suggests agreeing with hypothesis 7. This result disagrees with the findings of Di Pietra et al. (2008), based on Italian companies, who find a positive and significant association of directors’ multiple directorships with market performance. Similarly, my findings do not support the findings of Jensen (1993), Core et al. (1999), Shivdasaini and Yermack (1999), Jiraporn et al. (2009), Devos et al. (2009), Sharma (2011), Cashman et al. (2012), Andres et al. (2013), Falato et al. (2014), where they show a negative association between the presence of busy directors and firm performance. They argue that board busyness could compromise monitoring quality of board due to ‘attention shocks’ of overstretched directors. My findings also do not corroborate with Jackling and Johl (2009), based on a sample of top Indian companies, who find a negative effect of multiple directorships of directors on firm performance. They further suggest that busyness does not add value in terms of networks and enhancement of resource accessibility.

My empirical evidence does not demonstrate a firm link of directors' busyness with the resource-dependence theory. Directors holding multiple directorships may not bring information and other resources valuable for companies. The Companies Act 2013 mandates the Indian listed companies that an individual director shall not hold office as a director in more than twenty companies at the same time<sup>39</sup>. However, from the financial perspective, the findings for the sample companies do not support this level of regulatory intervention in limiting board busyness.

***Board activities and firm performance:*** Board activities include frequency of board meetings in a year and an average attendance of directors in such meetings. The regression results show no significant association between board meeting frequencies (BodMeet) and all forms of firm performance measures. These results agree with Jackling and Johl (2009), for a sample of large Indian companies, who document no association between the number of board meetings and firm performance. The results do not support either of the theories, i.e. agency or resource-dependency, because the frequency of board meetings are neither reducing agency costs nor bringing resources to enhance firm performance.

Likewise, the results do not support Brick and Chidambaran (2010), based on a sample of US firms, who find a positive and significant relationship of the number of board meetings with firm performance. Likewise, they also do not agree with Vafeas (1999), based on the sample of US firms, who find the annual number of board meetings inversely related to firm value.

Similarly, the regression results for the relationship between board meeting attendance and firm performance are statistically not significant, suggesting agreeing with hypothesis 8. That is, directors' average attendance on board meetings is unrelated to firm performance. It implies that directors usually make a little contribution by attending board meetings. These findings support Masulis et al. (2012) for US firms, and Hahn and Lasfer (2016) for UK firms, who find no empirical evidence of a link between directors' board meeting attendance and financial performance. They do not

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<sup>39</sup> See the Companies Act 2013, 165(1)

agree with Lin et al. (2014) and Chou et al. (2013), for the sample of Taiwanese firms, who find a positive association between directors' attendance and performance, and also with Liu et al. (2016) for Chinese firms.

In India, directors attend board meetings, evidenced by the average attendance of 84 per cent in my sample (see Table 4.4), but they are unable to interact with each other actively and affect firm performance. Merely attending board meetings and approving the principal directors' agendas do not bring resources into the firms. Instead, there should be an environment for inside and outside directors to have an open discussion, ideas sharing, and sense of shared ownership on board decisions to have real impacts on firm value and performance.

***Boardroom gender diversity and firm performance:*** The regression coefficients of the percentage of women directors (BoDGD) and firm performance (ROA and ROE) suggest disagreeing with hypothesis 9, that boardroom gender diversity is negatively associated with firms' accounting performance. This result supports the findings of Ahem and Dittmar (2012) for Norwegian companies. They find that the quota system, imposed by the laws in Norway, caused a significant drop in the stock prices at the announcement and a significant drop in firm performance over the following years. The regulatory push for gender quota led to the recruitment of younger and less experienced directors that resulted in a deterioration of firm performance. My findings are contrary to Luckerath-Rovers (2013), for Dutch companies, that, firms with women directors perform better than those without women on their boards. They also disagree with Terjesen et al. (2016) for a multi-country (47 countries) study of board diversity that the firms with more female directors achieve higher market performance (Tobin's Q) and accounting performance (ROA). My results for accounting performance also contradict with Chapple and Humphry (2014), for 300 largest Australian firms, where they do not find any evidence of an association between boardroom gender diversity and firm performance. Moreover, with Chauhan and Dey (2017) for 3000 firms in India, where they document that the female directors did not contribute to firm performance.

In India, the Companies Act 2013 mandates a board seat for women in all listed companies. After the enactment of the law, the number of companies appointing

minimum one woman director has been spurred dramatically (see Table 4.1). However, appointing only one woman director on the board as a token, or two women directors as a few tokens, seems to be inexpedient as they will be categorized, stereotyped, and ignored by the majority of male directors. The minority women directors have to conform to the business ideas and decisions of the majority. The minorities are rarely encouraged to make any contributions (Torchia et al., 2011). Hence, for the full potential of women talents, firms need to have gender-balanced boards by increasing the proportion of women directors. The gender-balanced boards are more active at board activities (Schwartz-Ziv, 2017), i.e. boards with the critical mass of women directors, i.e. with three or more directors, have stronger positive impacts on CG and firm performance than the boards with two or fewer women directors (Liu et al., 2014).

According to Terjesen et al. (2015), the establishment and successful implementation of legislation for the gender-balanced board is explained by an integrated model of three institutional factors, such as female labour market<sup>40, 41</sup> and gendered welfare state provisions (e.g. maternity leave, childcare, etc.), government and political institutions, and path-dependent policy initiatives for gender equality, both in public as well as in the corporate realms. In India, these institutional environments for quota legislation for women's participation in corporate leadership roles are in nascent stages and restricted by various social, cultural, and political norms creating social inequalities hindering women's advancement (Agnihotri and Malipatil, 2018). Chauhan and Dey (2017) highlight three constraints associated with the poor performance of female directors. They include: a) the corporate boards' quotas are occupied by unenthusiastic or unprofessional female members of the family in the name of compliance; b) firms are limited to include qualified female directors in their boards due to the inadequate supply of professional female directors; and c) being a patriarchal society males mostly control

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<sup>40</sup> Thomas (2012) provides constraining female participation in the Indian workforce and argues that the extremely low rate of female participation is one of the biggest hurdles for labour market modernization in India. It shows the number of missing women in India, i.e. women who withdraw from the labour force and who engage only in domestic duties, is 216 million in 2009-10.

<sup>41</sup> Das et al. (2015) provide that at the national level, India's female labour force participation (FLFP) is 33%, well below the global average of around 50%. India's gender gap in the labour force participation is one of the widest among G-20 economies and furthermore, the FLFP has been on a declining trend in India.

most of the decision makings and the presence of female directors is likely to be acknowledged as a token for attaining the legislative requirements or showcasing the welfare of females. The findings of this paper suggest that the minimum representation of women on the boards does not improve firm performance. The implied intention of the law for just a minimum representation of women on boards cannot be linked to the economic perspectives. Instead, it seems that the lawmakers are motivated by reasons other than improvements in governance and firm performance, i.e. the ethical reasons because it is immoral or unethical to exclude women from decision-making roles of modern corporations because of their gender and it is intended to create a fairer and more equitable society.

***Changes in regulatory approach and impact on CG and firm value:*** In one hand, there is a strong view that the changes in regulatory approach should have a positive impact on CG and firm performance. Changes in CG rules could produce market value gains to the investors by improving CG standards, corporate boards' functioning, increasing overall firm value and reducing the private benefits of insiders (Balasubramanian et al., 2010; Udaysankar and Das, 2007). Firm performance is higher in countries with better legal rules and quality of law enforcement (LaPorta et al., 1997). On the other hand, some authors, such as Westphal (1998) and Romano (2005), argue that the corporate boards are cosmetic, with no effect on firm value. If the boards are merely cosmetic and window-dressing, the forced changes in board characteristics through changes in regulatory approach will have no effect on firm performance (Helland and Sykuta, 2004).

India has long been criticized for the lack of enforcement of its rules and the slowness of its justice system, an ineffective market for director reputation and low litigation risk (Narayanswamy et al., 2015). The Companies Act 2013 has introduced extensive revisions of the laws related to CG, leading to substantive changes in the structure and functioning of boards of directors, board committees, and management. The changes in the Act have far-reaching implications that are set to significantly change the manner in which corporate operate in India. The announcement of the Law was not made in an unusual manner, because the MCA has gone through several consultation processes

with experts, practitioners, and business people before drafting the Companies Bill and debated by the members of parliament and finally enacted as the Law.

In my analysis, the regression result shows that none of the dummy variables to measure exogenous variation due to the mandated changes in board characteristics have a statistically significant association with firm performance. The companies were deliberately prepared for any changes in the CG requirements. As a result, they did not experience any unexpected immediate shock from the shifting of the principle-based approach of CG to the rule-based approach. However, based on the regression results I hesitate to make any firm inference on this issue. I choose 2013 as the base year because the Companies Act 2013 was introduced in August 2013 and some of the provisions of the Act were made effective from 12 September 2013. The MCA circulated to all the concerned that all rules published under Companies Act would be fully effective from 1 April 2014. My sample period is from 2010/11 to 2014/15, hence provides one years' data, i.e. 2014/15, for the analysis of the impact of regulatory shift after full enactment of the Law. Therefore, the regression analysis is not providing any significant result because the data is not enough to perform a natural experiment of an important regulatory shift in India. Further research is required by expanding the sample period and the number of observations.

## **4.8 Conclusions**

This paper presents empirical evidence on the relation between the boards of directors as CG mechanism and firm performance in India. The paper argues that the characteristics of the boards of directors sufficiently reflect the quality of CG. Using data of 149 to 155 non-financial firms representing a diverse sector of the Indian economy and a variety of board characteristics, it investigates whether there is an association between the two. It uses firm size, leverage, firm-specific effects, and year effects as control variables, and three different measures of firm performance, i.e. Tobin's Q, ROA, and ROE in investigating whether the quality of CG is related to performance indicators.

The paper applies the system GMM estimation method, which accounts for all types of endogeneity issues in the investigation of CG-performance relationship and takes internally available variables as instrumental variables. The system GMM estimation is believed to be suitable for the panel dataset with small '*T*' and large '*N*'. The findings of the investigation are robust as described by the Hansen test, Wald  $\chi^2$ , and Arellano-Bond Test (AR1 and AR2) and the test statistics show the regression models are significant. The regression results show that the association between some of the board characteristics variables and firm performance are as expected.

This paper finds that board independence, as proxied by directors' independence, is negatively affecting firm performance. These findings in India contradict with the findings in Anglo-American contexts. For example, Fama and Jensen (1983), Hillman and Dalziel (2003), McDonald et al. (2008), Chhaochharia and Grinstein (2009), Ozkan (2011), and Bhagat and Bolton (2013), who report that the independent directors help in closely and effectively monitoring and evaluating managerial behaviour and implement successful strategies, thus contribute to firm performance. Outside directors may lower the effectiveness of their roles as monitors because of their diverted focus, low/no business experience, and personal links to the owners' families, groups, and principal owners. Directors' tenure shows a positive association with firm performance implying that directors with long terms in their office tend to be more familiar with board process, business activities, and have more interactions with stakeholders. Moreover, because of the strong identification, long-serving directors provide additional resources or monitor management to bring maximum benefits to the organization (Hillman et al., 2008).

In terms of boardroom gender diversity in India, the present law mandates all listed companies to have at least one woman director on their boards. This token system may ensure at least one female face on the list of board of directors. However, the empirical result shows that the minimum representation of women on boards does not enhance the firm performance of the companies. The government is motivated from the ethical reason for a mandatory seat reserved for women on boards of directors. For the stronger impact on firm performance, companies should have gender-balanced boards, at least having a critical mass, i.e. three or more women directors rather than having their thin

representation (Liu et al., 2014; Schwartz-Ziv, 2017). The result suggests to the regulating bodies in India for review of existing laws and mandate companies to have more women directors on their boards (at least to the critical mass) to enhance the full advantage of diversity from both the ethical and the economic points of view.

Past performance, as measured by one year lag of performance variables, has substantial positive impacts on current year's firm performance suggesting the presence of dynamic endogeneity. Firm size continues to have a negative relationship with all forms of performance indicators. Similarly, the results show that board size, multiple directorships of directors, directors' remuneration, board activities, and leverage have no significant association with performance indicators, whereas, board leadership structure and directors' age are partially related to firm performance in India.

The findings, presented in this study, are subject to some important limitations and should be taken into account when interpreting the results. First, it is based on the sample companies from one of the largest emerging economies, India. Studies using samples from multiple emerging and advanced economies would minimize the potential risk associated with its generalization. Second, this study uses a small sample of listed companies in India. Further extension of the study is required, taking a bigger sample to widen its scope of generalization. This study is unable to provide any firm inference about the impact of changes in the CG laws from principle-based approach to rule-based approach on firm performance because of the limitation of data. However, it provides the basis for future research considering the effects of the contemporary regulatory reforms, such as the Companies Act 2013 and IBC 2016, on firm-level CG and performance.

## 4.9 References

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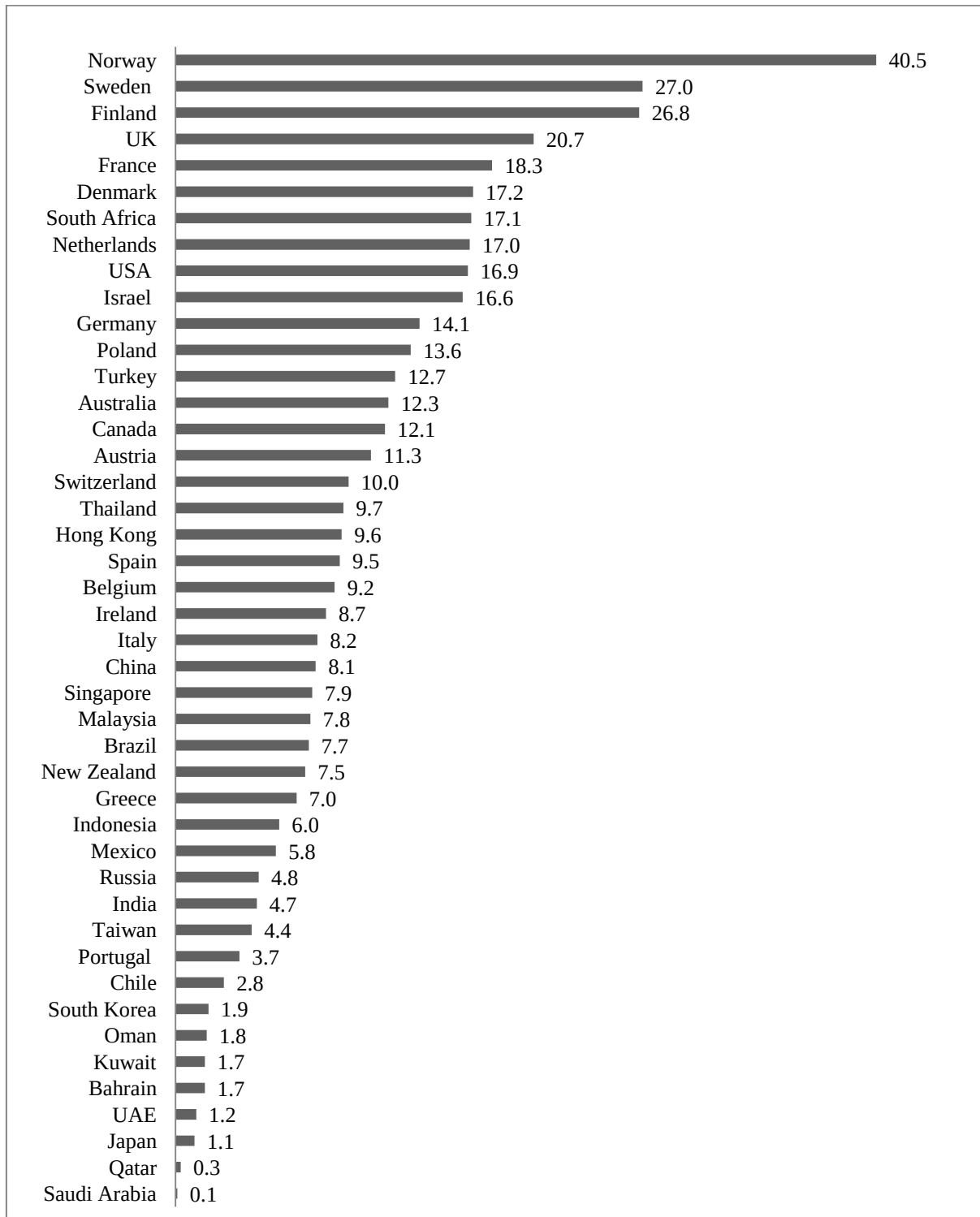
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## Appendix 4.A: Percentage of board seats held by women, by country



Source: Catalyst (2014b) *Board Seats Held by Women, by Country*. Available at: <http://www.catalyst.org/knowledge/board-seats-held-women-country> (Accessed: 2 July 2015).

## **Chapter 5: Ownership Structure and Firm Performance: Evidence from India**

### **Abstract**

This study examines the relationship between ownership structure and firm performance in a sample of large Indian companies listed on the Bombay Stock Exchange and the National Stock Exchange. The sample consists of about 150 companies for five years from 2011 to 2015 with 753 total firm-year observations. I consider institutional ownership, family business, promoters' ownership, promoter directors' ratio on boards, non-executive directors' ownership, government ownership and the number of blockholders as ownership related variables, and Tobin's Q, ROA and ROE, as firm performance variables. Firm size and leverage are the control variables. Also, I controlled time-variant effects and firm-specific effects while setting up a panel dataset.

I find a mixed association of ownership variables with firm performance. The institutional investors' and promoter groups' ownerships are positive with Tobin's Q, but they do not relate to ROA and ROE. Non-executive directors' ownership has no relationship with Tobin's Q. Family control is positive with ROA and ROE and negative with Tobin's Q. NEDs' ownership percentage shows a negative association with ROA and ROE. The number of blockholders has a positive association with Tobin's Q and negative with ROA and ROE. Government ownership and the proportion of promoters on boards of directors are not associated with firm performance indicators.

This study is important because of a couple of reasons. First, it expands the existing CG literature with a less explored and ignored area of CG, i.e. ownership structure in an emerging market context. Second, the new evidence from India, in terms of the impacts of corporate ownership and control by institutional investors, families, promoter groups, government, and multiple blockholders on performance indicators, are distinct from other developed and emerging economies. It also provides some policy advice and directions for future research.

Keywords:

Ownership structure, institutional ownership, family control, promoter groups, blockholders, non-executive directors, government ownership, firm performance

## **5.1. Introduction**

As early as 1932, Berle and Means, in their classic work, *The Modern Corporation and Private Property*, point out the fundamental principal-agent conflict in modern corporations due to the separation of ownership and control. They report an inverse relationship between dispersed shareholdings and firm performance because the control power concentrates in the hands of managers. The ownership concentration on a few large shareholders provides efficient monitoring effect and management exercises less freedom in expropriating firms' resources. Since then, there is an ongoing debate in corporate finance literature about the relationship between ownership structure and firm performance.

The central theoretical framework to this analysis is agency theory that explains the conflicting interests between shareholders (who own the firms) and managers (who run corporations) (Jensen and Meckling, 1976). The ownership structure is a primary determinant of agency problems and also one of the vital CG mechanisms which have significant implications on firm performance (Lemmon and Lins, 2003). The separation of ownership and control encourages managers for diversification (activities that increase managerial benefits and reduce shareholder value). But the presence of large and institutional shareholders can pressure managers to reduce such diversification and improve firms' financial performance (Thomsen and Pedersen, 2000). The existing literature has widely documented empirical findings on the ownership - performance relationship, especially paying attention in the samples from advanced economies (mainly from the USA and UK) (DeMiguel et al., 2004). In these economies, the firm-level CG systems are different from other economies because of the firms with diffused ownership resulting in agency conflicts between unmonitored managers and small shareholders (Perrini et al., 2008).

However, very few empirical evidence are available in emerging and developing economies, and moreover, the evidence available in advanced economies are less

applicable to other economies (Jackling and Johl, 2009; Black et al., 2012; Claessens and Yurtoglu, 2013).

Prior studies have shown that ownership matters for firm performance, where they have used four types of ownership. First, institutional ownership that controls managerial hegemony reduces information asymmetry and improves firm performance (Elyasiani and Jia, 2010; Baysinger et al., 1991; Ben-Amar et al., 2013). Second, family ownership, that has a powerful influence on the ways of operating business, ultimately affects firm performance (Barth et al., 2005; Ben-Amar et al., 2013; Andres, 2008). Third, ownership shares held by managers/directors' affect their inclination to maximize shareholder value rather than pursue managerial objectives (Jensen and Meckling, 1976; Bauguess et al., 2009; Belkhir, 2009; Bhagat and Bolton, 2013). And fourth, ownership concentration provides large owners (blockholders) with incentives to take an active interest in the firm and to monitor its managers (Shleifer and Vishny, 1986; Belkhir, 2009; Konijn et al., 2011; Andres, 2008). Firms' agency costs vary with their ownership structure. For example, agency costs are higher when an outsider manages the firms; inversely relates with managers' ownership shares; and increases with the number of non-manager shareholders (Ang et al., 2000). In some large emerging economies, e.g. China and India, the Government owns a significant number of listed companies. Government ownership of business firms results in poor governance quality (Borisova et al., 2012), but it may represent a strategic asset rather than an agency cost burden (Le and Buck, 2011).

This paper investigates the relationship between ownership structure and firm performance of large Indian companies and establishes the generality of the results documented in developed markets to the emerging markets. The economic and institutional settings in India are unique than those of the western and other developed economies. For examples, the Indian corporate sector is characterized by concentrated ownership, dominance of family and controlling shareholders, group affiliation, separation of voting and cash flow rights, limited protection of minority shareholders' rights (Driffield et al., 2007), weaker external control mechanisms such as ineffective market for corporate control, insufficient laws for merger and acquisition, and unpredictable enforcement mechanisms (Gopalan et al., 2007; Dharmapala and Khanna,

2013; Branch and Khizer, 2016). Concentrated ownership coincides with a lack of investor protection because unprotected owners will seek to protect themselves by becoming controllers. They can achieve ownership control through pyramid structures in which one firm controls other firms (Lins, 2003)

The ownership patterns of Indian companies have been changing because of opening Indian corporate sectors for foreign investors. India has been attracting sizable foreign direct investment (FDI) inflows and now is ranked as 9th largest countries in the world attracting FDI. In 2005 the FDI inflow was USD 7.6 billion (6 per cent of country's GDP) which increased to USD 40 billion and 42 billion in 2017 and 2018 (i.e. 15 per cent of GDP), respectively (OECD, 2019) (See Appendices 5.A (I & II)). The increasing trends in FDI inflows and the less restrictive policy of the Government in foreign investment (ownership) result changes in ownership patterns of companies (Asiedu and Esfahani, 2001). And understanding the changing ownership pattern is vital to the investors because it affects their incentives to apply their resources in the host country.

Interestingly, many Indian companies are state-owned and trading publicly as other listed companies, which do not have parallels in the USA and UK contexts. Many economists think SOEs are the outdated form of business organizations, particularly in the western economies (Dewenter and Malatesta, 2001). Based on this premise, the CG regulators in the USA and UK prepare CG norms with the assumption that the private sector is controlling the companies. However, SOEs appear as the enduring and influential forces in the Indian economy; hence, the CG norms prepared in the western context can be ineffective in India (Subramaniam, 2015). Studying Indian context could enhance our understanding of the impact of ownership structure on firm performance of listed companies in a different institutional framework. This paper includes ownership related variables, such as institutional ownership, family in the business, government ownership, promoters' ownership, promoter directors' ratio and blockholders' dispersion, and firm performance indicators. For this purpose, I put forward the following research question:

*Does the ownership structure have impacts on firm performance?*

From a theoretical perspective, the paper expands current notions of monitoring effectiveness through ownership structure in an emerging market context, India, which has received little attention and, due to nation-specific factors, agency impact in India may differ from the Anglo-American context. The new evidence from an emerging economy will be a departure from the domination of Anglo-American and other developed economies evidence. Researchers, e.g. Hoskisson et al. (2000), and Wright et al. (2005) suggest to accounting for the unique institutional contexts of emerging economies and challenge the conventional theories and methods derived from more advanced economies. From a practical perspective, the empirical findings, related to the impacts of ownership structure on firm performance, are useful for individual firms, investors and regulators. Firms can offset monitoring effectiveness through the ownership mix to enhance firm performance. Investors, particularly institutional investors, can consider how to develop the necessary monitoring capacity to control managerial activities. Similarly, the regulatory bodies may pay attention to ownership structure to fulfill the increasing demand for stronger CG.

I organize the remaining sections of the paper as follows. Section 5.2 reviews the literature on ownership structure and firm performance and devises testable hypotheses. Section 5.3 outlines data and methodology, variables of interest, and regression models. Section 5.4 provides empirical results. Section 5.5 discusses the results. And finally, section 5.6 presents a summary and conclusion of the paper with some limitations of the study and areas for future research.

## **5.2. Literature review and research hypotheses**

In the extant literature, ownership structure, as one of the governance mechanisms affecting firm performance, has received a significant attention from the corporate finance scholars, investors, and policymakers. McConnell and Servaes (1990) argue that firm performance depends on the allocation of share ownership among insiders and outsiders of the firm. Although there is a proliferation of studies in the USA, UK, and other developed economies related to the effects of ownership structure on firm performance, their findings are mixed and inconclusive (Perrini et al., 2008). In this

section, I review relevant literature from around the world and from India, and develop testable hypotheses.

### **Institutional ownership and firm performance**

Institutional investors are the most active owners, often confronting managers and directors, and even seeking changes on board structure and top management (Connelly et al., 2010). Institutional owners are the source of external influences on corporate strategy and performance (Chaganti and Damanpour, 1991). The percentage of corporate equity holding of institutional investors is increasing rapidly, which is affecting the power relationship in a firm and subsequently affecting firm performance. As reported by Malin (2012), institutional shareholders own over 55 per cent of US equity, and 43 per cent of UK equity; hence, institutional shareholders wield significant power in the USA and UK CG systems. Institutional investors provide substantial amounts of capital to the firm. They play an active role in monitoring and influencing managerial decisions (Hartzell et al., 2014). As the percentage of shares ownership increases, the institutional owners put forward more influence over the firm and monitor more actively (Dharwadkar et al., 2008).

Most prior studies have provided a positive and significant association between institutional ownership and firm performance. In a sample of US manufacturing firms, Han and Suk (1998) find a positive relationship of institutional ownership with firm performance, measured by Tobin's Q. It indicates that institutional owners are actively monitoring managerial hegemony, and the market takes the presence of institutional investors positively. Elyasiani and Jia (2010), in a sample of US firms, find that institutional ownership reduces information asymmetry and improves long-term firm performance. Attig et al. (2013) find institutional investors with long-term investment horizons provide valuable monitoring and informational roles. These roles, in turn, reduce agency costs and information asymmetry problems, resulting in a higher price of equity shares. These findings imply that a firm's management needs to build and maintain a long-term relationship with institutional investors to improve their firm performance. Boone and White (2015) report a positive impact of higher institutional ownership on firms' information disclosure and information asymmetries, which

enhance monitoring costs and decrease trading costs. McConnell and Servaes (1990) find a strong positive relationship between institutional ownership and firm performance (Tobin's Q). Cornett et al. (2007) confirm the same with a significant positive association of the proportion of institutional shareholdings as well as the number of institutional owners with operating performance of the large US firms.

Similarly, Dong and Ozkan (2008), in an empirical study of UK companies, show that dedicated (long-horizon) institutional owners involve more in CG and serve better monitoring and disciplining roles. Sharma (2004) reports that the percentage of institutional ownership increases, the likelihood of fraud decreases in Australian companies because institutional investors effectively perform a monitoring and controlling function in the context of fraud. Lin and Fu (2017), in a sample of Chinese listed companies, find a significant and positive relationship between some types of institutional ownership and firm performance. Only the pressure-insensitive, foreign and large institutional owners have greater positive effects on firm performance but not from the pressure-sensitive, domestic and small institutional investors. However, Navissi and Haiker (2006), in a sample of listed companies in New Zealand, report that the relationship between institutional ownership and firm performance is positive at lower ownership level of institutional investors and the relationship becomes negative with the increase in institutional share ownership level.

In India, Chakrabarti et al. (2008) show that the institutional investors (both domestic and foreign) hold a significant amount of equity shares of large Indian companies (i.e. 30 per cent). However, the authors do not provide any empirical evidence linking them with firm performance. Ramaswamy et al. (2002) report that institutional investors' equity ownership inversely relates to unrelated (risky) firm diversification. Institutions are the pressure-resistant investor groups and are sensitive and active in monitoring which are precursors to successful wealth creation. Arora and Sharma (2016) find a positive and significant relationship between institutional investors and market performance indicator but the relationship is not statistically significant with other performance indicators. They do not provide any clear argument behind the existence of such a relationship. Pant and Pattanayak (2010) find that institutional investors' shareholding is insignificant in enhancing firm productivity of Indian companies.

The above arguments suggest the lack of research that examines the relationship of institutional ownership with firm performance in the Indian context. Based on the existing literature around the world, I predict that institutional ownerships have a positive influence on firm performance that arises from the assumption that institutional owners have an incentive to monitor efficiently and to check the insiders' hegemonies. Hence, the following null hypothesis:

*Hypothesis 1: Institutional investors' equity shareholding is associated with firm performance in India.*

### **Family ownership and firm performance**

Family ownership and control is a common phenomenon of the ownership structure of corporations around the world (Burkart et al., 2003), constitutes about one-third of S&P 500 companies, and operates in a broad array of industries (Anderson et al., 2003). Family ownership has an informal but powerful influence on the ways of doing business with both positive and negative effects on performance. In one hand, family ownership and control may reduce agency costs (Type I agency problems) by aligning ownership rights with control rights (Jensen and Meckling, 1976; Maury, 2006). And, on the other side, family's equity ownership and control may misuse resources at the expense of nonfamily minority shareholders and in turn, can adversely affect firm performance. Notwithstanding ownership concentration on families may mitigate Type I agency problem (conflicts between owners and management), it may produce Type II agency problems (also known as a secondary agency problem or principal-principal conflicts, i.e. conflicts between controlling shareholders and minority shareholders) (Young et al., 2008; Burkart et al., 2003).

Anderson and Reeb (2003) examine the relationship between family ownership and firm performance of S&P 500 firms and find family-owned firms are performing better than nonfamily-owned firms. The interpretation is that the family members better understand the business and involve themselves as the true stewards of the firm. Villonga and Amit (2006), in a sample of all Fortune-500 firms, find that family ownership creates firm value only when the founder serves as CEO. It implies that family ownership creates

value only by combining family control and management. Klein et al. (2005), for a sample of 263 Canadian firms, analyze the relationship between CG, family ownership and firm value (Q). In contrast, they find the effect of family-owned firms on firm performance a negative and significant. Similarly, Miller et al. (2007) find no longer any evidence of superior market valuations of the family business category of the Fortune 1000 firms.

In Germany, family firms are not only profitable but also successfully balance the two agency problems, i.e. owner-manager conflicts on the one hand and minority shareholder expropriation by a controlling shareholder on the other side (Andres, 2008). Maury (2006), in a study of western European corporations, shows that active family ownership improves firm profitability and passive family ownership does not. The author further suggests that family management may significantly increase the efficiency and profitability of the firm. If it does not contribute to the firm value, the minority shareholders will not get any benefit. Minichilli et al. (2016) observe a significantly and consistently better performance of family-controlled firms in Italy during the presence of external hazards, i.e. financial and economic crisis of 2008/09. It shows the resilience of family-controlled firms that they are more capable of absorbing exogenous shocks than others.

Jiang and Peng (2011), based on the sample of eight emerging economies from Asia, report that there is no concrete evidence documenting that family ownership is always 'good', 'bad', or 'irrelevant'. The effect of family ownership and control depends on the legal and regulatory provisions in the countries that protect minority shareholders. In a sample of Taiwanese firms, Wong et al. (2010) examine the impact of family control on firm performance of publicly listed companies on corporate venturing in Taiwan. They find that family control is significantly and negatively associated with firm performance during the corporate venturing announcement. Market participants, i.e. investors, may perceive family ownership as a disadvantage rather than a benefit regarding the venturing projects. However, institutional ownership has a significant positive moderating effect on the relationship between family control and firm performance. Filatotchev et al. (2011) investigate how family control affects private information abuses and firm performance in Hong Kong. They find that controlling ownership has

an incentive to manipulate business-related information and maximize the personal benefits of control.

Jameson et al. (2014) report that, of the sample of 1796 Indian companies, 63.2 per cent firms have families (founders) on the boards of directors, and on average, founders own over 50 per cent of outstanding equity shares indicating a significant ownership concentration on families and promoters. They find that nonfamily firms are doing significantly better market performance (Q) than family firms. Assets tangibility, long term debt ratio and capital expenditure are substantially higher in family-controlled firms. Lodh et al. (2014), using an unbalanced panel of 395 BSE listed firms in India for 2001-2008, find a positive impact of family ownership on innovation productivity. In a sample of 101 listed companies in India, Singla et al. (2014) examine the nuances in behaviour or goals/preferences of family-controlled and nonfamily controlled firms about the internationalization-governance relationships. And they find that family firms, which are in the internationalization process, adopt suboptimal governance structure so that private non-pecuniary benefits of control are better enabled. Notwithstanding having existing literature on family ownership and control, there is no fine-tune about their impact on performance. Hence, the following hypothesis:

*Hypothesis 2: Family ownership and control are associated with firm performance in India.*

### **Promoter directors and promoter group ownership and firm performance**

Promoters are the person or group of persons who are involved in the incorporation of a business organization. They are an integral part of CG in India because the promoters manage and control a majority of Indian firms (Chakrabarti et al., 2008). The SEBI defines the term promoter as, “a person or persons who are in control of the company or persons, who are instrumental in the formulation of plans or programs of the companies” ([www.sebi.gov.in](http://www.sebi.gov.in)). Mostly, promoters retain control of company resources, and their shareholding is a proxy for ownership concentration (Ganguli, 2013), or the cash flow rights (Ghosh, 2010). Promoters have better access to superior information about company affairs than any other shareholders and have considerable power and

influence on boards and managements in vital strategic decisions. The boards and management are forced to follow the directions of promoters, which restricts the independent decision-making capacity of other professional directors and management.

The presence of promoters with substantial ownership stakes is the most common ownership phenomenon in emerging economies like India. Kumar and Singh (2013) report that an average of 51 per cent equity ownership in small companies, and 56 per cent in large companies, are held by promoters. Mishra and Mohanty (2014) report that the promoters own 56 per cent of equity shares of the BSE companies, and Mishra and Kapil (2017) document 55 per cent of equity ownership of the CNX 500 companies.

The promoters, as the internal controlling owners, may seek to extract and optimize their benefits at the costs of outside minority owners (Sarkar and Sarkar, 2012), leading to a secondary level of agency problems, i.e. conflicts between controlling and minority owners (Shleifer and Vishny, 1997). The controlling shareholders (promoters) obtain incentives for the expropriation of minority shareholders' value using pyramid structures and cross-holdings among firms (Claessens et al., 2000). Ghosh (2010) argue that the promoters have an incentive to transfer funds from the firms in which they have low ownership stake to the firms in which they have a high stake. According to Young et al. (2008), the controlling shareholders may siphon off minority shareholders' value in three ways: 1) by putting less-than-qualified family members, relatives, friends, and cronies in vital posts; 2) by purchasing supplies and materials at higher prices or selling products and services at lower prices to organizations owned by, or associated with controlling shareholders; and 3) by engaging in setting strategies which favour personal benefits, family interests, or political agendas at the costs of financial performance. Hence, companies with a relatively lower promoter's share are likely to be worse off from tunnelling of resources to other companies with a higher proportion of promoter's shares.

However, empirical evidence on the relationship between promoter ownership and firm performance shows a mixed result. Mishra and Kapil (2017) and Kumar and Singh (2013), for Indian companies, find a significant positive association of promoter

ownership with firm performance indicators. It implies that higher ownership rights give the promoter enough incentives to control, monitor, and enhance firm value. In contrast, Ghosh (2010), for listed companies in India, documents no association between promoter ownership and firm performance. While showing a causal relationship between ownership variables and performance indicators, these papers have not made any adjustment for endogeneity issues, especially encountered in the examination of the ownership-performance relationship. Therefore, these studies are unable to provide a picture portraying the effects of promoters' ownership on performance indicators correctly. Hence, the following null hypothesis:

*Hypothesis 3(a): Promoter directors and promoter groups' equity ownership is associated with firm performance in India.*

Corporate boards include directors from inside (promoters and managers) and outside (independent directors). Promoter directors are internal directors with more excellent firm-specific knowledge to effectively oversee firm operations and investment activities (Masulis and Mobbs, 2011). They have a substantial control on ownership, board procedures, strategic decisions, and overall businesses of the firms. However, because of the legal mandates for higher board independence, the numbers and proportions of promoter directors on corporate boards have been decreasing. In India, my sample data shows that promoters hold more than 59 per cent of ownership shares. But their board appointments are not matching with the proportion of their share ownership, i.e. only 30 per cent of board seats are held by promoters (see Table 5.3: Descriptive Statistics). The Companies Act 2013 has limited the appointment of promoter directors by mandating listing companies to appoint a majority outside directors in the boards, and independent directors in the board committees (i.e. Audit and Remuneration Committees). The promoter directors, in the minority, are unable to provide valuable inputs to board deliberations regarding the managerial activities. In that situation, the management may enjoy a considerable advantage as a result of information asymmetry and encourage managerial entrenchment, resulting in higher agency costs, and poor firm performance.

According to agency theory, promoter directors provide a critical internal monitoring function, affect the strategic direction of the firm, and minimize agency costs of

monitoring management. Hence, agency theorists advocate for increasing in the number of inside directors (Johnson et al., 1996), and balancing the corporate boards with an appropriate combination of outside and inside directors (Baysinger and Butler, 1985; Baysinger and Hoskisson, 1990). On the contrary, the empirical results suggest that boards, with a higher proportion of outside directors, do better monitoring (Helland and Sykuta, 2005). However, the prior literature has ignored to examine whether the percentage of inside promoter directors on corporate boards have any association with firm performance. Hence, the following null hypothesis:

*Hypothesis 3(b): The proportion of promoter directors serving on board is related to firm performance in India.*

Non-executive and independent directors hold the majority board seats<sup>42</sup> but are entitled to receive a nominal amount of incentives for their roles. In many countries, CG guidelines are not specific about the roles and incentives of non-executive directors (Hahn and Lasfer, 2011). The non-executive directors, in the USA and UK, are commonly referred to outside directors and they draw a cash-based remuneration (Goh and Gupta, 2016). In India, non-executive directors include affiliated outside directors and non-affiliated outside directors. The affiliated outside directors, also termed as ‘grey directors’<sup>43</sup>, include: non-promoter, non-executive, and non-independent directors. They are often in minority and hold some ownership shares (i.e. 0.09 per cent in my sample, see Table 5.3: Descriptive Statistics). But, the non-affiliated outside directors, also known as non-executive independent directors, do not hold any ownership share. Therefore, the variable of interest, ‘ownership shares of non-promoter and non-executive directors’, only includes the shareholdings of affiliated outside directors.

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<sup>42</sup> In the UK, the CG Codes require the listed companies’ boards to have at least 50 per cent independent directors; in India, the Laws require at least 50 per cent non-executive directors on the boards.

<sup>43</sup> Affiliated outside directors generally include “former company officers, relatives of the company officers, or those who have existing business relationships with the companies such as investment bankers and lawyers” (Sarkar et al., 2012: pg 4)

There is no empirical paper available in India, showing the association of non-promoter and non-executive directors' shareholdings with firm performance indicators. Hence, the following null hypothesis:

*Hypothesis 3(c): Non-executive directors' equity ownership is associated with firm performance in India.*

### **Government ownership and firm performance**

Government ownership is pervasive around the world and has significant consequences for economic and financial development (La Porta et al., 2002). Economists, who advocate for capitalism and open market system, usually view government ownership as being detrimental to corporate performance and as the root of organizational inefficiency. Shleifer (1998) contend that privately-owned firms fail to address social goals which are crucial for public welfare. The author further suggests that the government can resolve these goals through contracting and regulation, and even with resorting to the ownership.

Three alternative theories of state ownership, i.e. social, political, and agency, are commonly used to frame the debates related to the role of government ownership in the business (Sapienza, 2004). From the social theory of government ownership, firms are owned and controlled by the governments to maximizing economic development, general welfare, and address market failures. The political perspective of government ownership suggests that the government-owned and controlled firms are the mechanisms to fulfill the desires of politicians to emphasize political objectives rather than social objectives. Government acquires control of the firms to provide employment, subsidies, and other benefits to supporters and in return, to attract votes, political supports and bribes (Shleifer and Vishny, 1994). The government, via business ownership and control, intends to strengthen her political influences on the general public.

Similarly, the agency theory framework views that state-owned firms have difficulty in monitoring managers. In these firms, there are neither individual owners with strong incentives to monitor managers nor external market forces to control managerial actions

(Gupta, 2005). State-owned firms involve in stealing the firm's assets (taxpayers' money) through a 'grabbing hand' (a helping hand in opposite) of the government (Shleifer and Vishny, 2002). Compared to the principal-agent conflict of privately-owned companies, state-owned companies face new but complicated agency relationships, as the controlling owners are themselves as well as the agents of the real owners (Ding et al., 2007). Hence, the agency cost (moral hazard) of government ownership is higher than that of private ownership (Patibandla, 2006).

The issue related to the impact of government ownership on firm performance has a long debate in the literature, but the findings remain inconclusive (Liao and Young, 2012). Goldeng et al. (2008) examine the performance differences between private and state-owned firms in Norway. They find that companies owned and operated by the government systematically generate more unsatisfactory financial results as measured by ROA than that of the privately owned firms. They further argue that staff members of SOEs have lesser incentives to perform, and managers have inefficient means of monitoring and have minimum exposure to the market forces. In a comparative cross-country analysis of the profitability of state-owned and privately owned firms from the USA, Japan and UK, Dewenter and Malatesta (2001) affirm the above that government-owned firms are significantly lesser profitable than privately owned firms.

Similarly, Borisova et al. (2012), for EU-based companies, examine the impact of government ownership on firm CG and performance. They report that government ownership is generally harmful to the CG and performance, suggesting that firm value maximization is not always the primary goal of state owners. Borisova et al. (2015) examine the impact of government ownership on the cost of debt. They report that government ownership could carry an implicit debt guarantee that reduces the default risk and lowers the cost of debt, especially during the period of a financial crisis. They further contend that if government ownership increases moral hazards on managers, provides inefficient monitoring, and imposes burdens of social and political goals, will increase the cost of debt and diminish financial performance. It implies that the impact of government ownership on the cost of debt and profitability is conditional depending on general economic condition, firm characteristics, and the identity of the government entity.

Tian and Estrin (2008) examine the scale and impact of state-ownership on corporate performance in a sample of Chinese SOEs. They find the effect of government ownership on the firm value is non-monotonic, i.e. a curve showing the effects is U-shaped. It implies that up to a certain threshold, the firm value decreases with the increase in government ownership, and above the threshold, it increases. When government ownership is higher, Chinese firms are better off from the concentrated on government ownership. Le and Buck (2011) report a positive association between government ownership and firm performance of Chinese listed companies. They argue that the government-owned firms in the Chinese context may represent a strategic asset rather than an agency burden.

In India, government ownership remains widespread, government-owned firms are trading on the Western-style sophisticated stock market. The central and state governments in India have a significant amount of shareholdings of the companies, listed on the Bombay Stock Exchange and National Stock Exchange. However, government-owned companies in India are branded as the loss-making giants because they are characterized by inefficiency, overstaffing, and loss-making operations which are not driven by economic criteria (Abraham et al., 2015). For example, as reported by the Economist (2017), roughly one-sixth of government expenditure goes to state-owned firms, one-third of government companies made losses in 2015/16, and one-fifth of government companies have racked up three years of straight losses.

In India, there is very little empirical evidence on how government ownership affects firm performance. The available works largely support the contention that private firms achieve superior performance outcomes than government-owned enterprises (Ramaswamy, 2001). Ahuja and Majumdar (1998) examine sixty-eight manufacturing state-owned enterprises in India for five years from 1987-1991, find a low-level performance and low efficiency in resource utilization significantly. Ramaswamy (2001) uses a sample of large private and public sector manufacturing firms in India to examine the ownership structure, competitive intensity and firm performance. The study finds that state-owned manufacturing firms have weaker performance indicators compared to the private sector, and the magnitude of performance gap increases with an increase in competitive intensity. These findings suggest that, when the market moves

towards its perfection, the government needs to think for an alternative ownership arrangement of SOEs. Thakur et al. (2006), in a study of the state-owned electric utilities in India, report a similar result. They show a gradually increasing in the accumulated losses of the state-owned electric utilities from Rs. 50,000 million accumulated loss in 1993 to Rs. 250,000 million in 2001.

The available studies on the efficiency of government-owned firms are done mainly from the manufacturing sector compared with privately-owned manufacturing firms. They are ignoring the strategic goals of the government to own and control business firms. In this paper, I examine the relationship of ownership structures of state-owned enterprises in India with firm performance, showing how Indian SOEs are doing in market and profitability. The findings of my study are relevant to the debate on whether the privatization of state-owned enterprises is the remedy of their poor performance. Because everywhere, the trend in ownership is from state to private hands, rather than the other way around (Ramamurti, 2000). Hence, the following null hypothesis:

*Hypothesis 4: Government ownership and control is associated with firm performance in India.*

### **No. of blockholders and firm performance**

Thomsen et al. (2006) define the blockholders as “shareholders who own at least 5 per cent of a company’s common shares” (pp. 248). According to Jensen and Meckling (1976), one common view is that large owners (blockholders) may be effective monitors of managerial activities for the benefits of all shareholders. Blockholders can check managerial decisions and ensure that management does not expropriate rents from shareholders in the form of higher compensation (Dharwadkar et al., 2008). Blockholders help reduce agency costs and enhance firm performance. They may have access to or can develop private and value-relevant information by their roles as monitors of firms’ operations (Heflin and Shaw, 2000). Another view is that blockholders may use their power to maximize their benefits at the costs of many but minority shareholders (Fama and Jensen, 1983). Mainly, in emerging economies, the presence of blockholders may generate its own set of agency conflicts between

controlling shareholders and minority shareholders by controlling shareholders wielding substantial control and influence over firm decisions. This form of conflict is termed as the principal-principal conflict (or Type II agency conflict or secondary conflict), which is different from principal-agent conflicts (or Type I agency conflict or primary conflict) (Young et al., 2008). Hence, the theoretical relationship between large blockholders and firm performance is ambiguous (Dhaya et al., 1998; Thomsen et al., 2006). Prior literature on the relationship between blockholder ownership and firm performance has reported mixed results.

Bethel et al. (1998) report block shares purchases by the activists in the US corporations result in increases in asset divestitures, decreases in mergers and acquisitions, and abnormal share price appreciation. Blockholdings are associated with improvements in profitability and shareholder value. Activist investors tend to purchase block shares targeting poorly performed and diversified firms where performance improvements are possible. Similarly, Mak and Kusnadi (2005), for companies in Singapore and Malaysia, find a positive relationship between blockholders and firm performance, suggesting that blockholders act as efficient monitors and enhance firm performance.

McConnell and Servaes (1990) find no significant relationship between firm performance (Tobin's Q) and several alternative specifications of blockholder ownership of US firms. Thomsen et al. (2006) examine the relationship between blockholder ownership and the values of the largest companies in the EU and the US. The study finds no significant effect of blockholder ownership on firm value in the Anglo-American market-based economies but finds a significant negative impact on firm value and accounting profitability in Continental Europe. The study reveals that the association between blockholder dispersion and firm value is significant only for the firms with a high level of blockholders ownership, i.e. above 10 per cent. Similarly, Wright et al. (1996), and Mitra et al. (2007) conclude that in general, the presence of large blockholders does not significantly affect the performance of US firms. Andres (2008) concludes that blockholders (separating families) either affect firm performance adversely or have not detectable influence on the performance of German firms.

Jameson et al. (2014) and Bhaumik and Selarka (2012) have briefly discussed the issue of blockholdings in the Indian context; however, none of them has linked the effects multiple blockholders on firm performance. Based on one year's data of Indian companies, Selarka (2005) examines the impact of ownership concentration on firm value and finds no performance implication at lower and higher levels of block ownership, but reports a strong negative impact at a moderate level of block ownership.

Most of the prior literature stated above have used blockholder ownership percentage as a proxy for the power of shareholders but neglected to assess the effect of multiple blockholders on firm performance (Basu et al., 2016). The theoretical literature provides conflicting predictions on whether a single large blockholder or a set of dispersed smaller blockholders is better for firm value (Konijn et al., 2011). Boateng and Huang (2017), in a sample of Chinese listed companies, find multiple large shareholders (blockholders) constitute a critical internal CG nexus. Blockholders control value-destroying excess leverage policy and mitigate resource tunnelling by controlling shareholders in an environment where the CG system is weak. Using US data, Konjin et al. (2011) report a negative association between blockholder dispersion (number of blockholders) and firm performance (as measured by Tobin's Q). Basu et al. (2016) document the presence of multiple blockholders in a vast majority of US firms and shows that blockholders dispersion as the dimension of ownership structure other than power. In particular, "should the policymakers encourage more concentrated blockholdings or support for splitting the ownership into a multiple small blockholders", is not empirically explored in India.

I examine empirically whether multiple blockholders have any association with the firm performance of Indian companies. Hence, I developed the following hypothesis:

*Hypothesis 5: The presence of multiple blockholders is associated with firm performance in India.*



## 5.3. Methodology

### 5.3.1. Data

The following is a table (Table 5.1) of information about the sample of large companies, from diverse sectors of Indian economy, listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

**Table 5. 1: Number and percentage of firms by industry classification**

| Sector                  | No. and percentage of companies selected |       |      |       |      |       |      |       |      |       |
|-------------------------|------------------------------------------|-------|------|-------|------|-------|------|-------|------|-------|
|                         | 2011                                     | %     | 2012 | %     | 2013 | %     | 2014 | %     | 2015 | %     |
| Pharm. & Biotech.       | 16                                       | 10.32 | 17   | 11.41 | 15   | 9.93  | 19   | 12.75 | 19   | 12.75 |
| Personal Goods          | 14                                       | 9.03  | 12   | 8.05  | 12   | 7.95  | 11   | 7.38  | 10   | 6.71  |
| Electricity             | 14                                       | 9.03  | 14   | 9.40  | 15   | 9.93  | 13   | 8.72  | 14   | 9.40  |
| Construction/Material   | 14                                       | 9.03  | 14   | 9.40  | 11   | 7.28  | 13   | 8.72  | 9    | 6.04  |
| Oil & Gas               | 11                                       | 7.10  | 10   | 6.71  | 10   | 6.62  | 10   | 6.71  | 10   | 6.71  |
| Ind. Metals & Mining    | 15                                       | 9.68  | 14   | 9.40  | 13   | 8.61  | 10   | 6.71  | 10   | 6.71  |
| Industrial Engineering  | 10                                       | 6.45  | 9    | 6.04  | 9    | 5.96  | 10   | 6.71  | 8    | 5.37  |
| Automobiles & Parts     | 8                                        | 5.16  | 8    | 5.37  | 9    | 5.96  | 10   | 6.71  | 10   | 6.71  |
| Software & Computer     | 7                                        | 4.52  | 8    | 5.37  | 10   | 6.62  | 9    | 6.04  | 9    | 6.04  |
| Chemicals               | 7                                        | 4.52  | 6    | 4.03  | 6    | 3.97  | 7    | 4.70  | 7    | 4.70  |
| Food Producers          | 5                                        | 3.23  | 5    | 3.36  | 4    | 2.65  | 5    | 3.36  | 4    | 2.68  |
| Telecom. & Media        | 8                                        | 4.52  | 8    | 5.37  | 10   | 6.62  | 8    | 5.37  | 9    | 6.04  |
| Electronic & Electrical | 3                                        | 1.94  | 5    | 3.36  | 5    | 3.31  | 5    | 3.36  | 5    | 3.36  |
| Other                   | 23                                       | 15.48 | 19   | 12.75 | 22   | 14.57 | 19   | 13.42 | 25   | 16.78 |
| Total                   | 155                                      | 100   | 149  | 100   | 151  | 100   | 149  | 100   | 149  | 100   |

Information related to financial performance, government ownership, family control, promoters ownership were obtained from Datastream for a sample of companies with large market value capitalization (MVC) from 14 industry classes over five years. Other board ownership structure related information, such as the number of blockholders, proportion of promoter directors, institutional ownership and equity ownerships of NEDs were compiled manually from multiple sources, as described in Table 5.2, below. Banks, and finance and insurance companies were excluded because of the special and intense regulatory environment in which they operate. As suggested by Vafeas and Theodorou (1998), regulation disguises efficiency of firms, potentially reducing the importance of governance mechanisms.

**Table 5. 2: Sources of ownership structure and firm performance data**

| <b>Data</b>                                                                                                   | <b>Source</b>                                                                             |
|---------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|
| List of companies, market value capitalization, ROA, ROE, data to calculate Tobin's Q, liquidity and leverage | Datastream                                                                                |
| Promoters shareholding, number of promoter directors, institutional shareholdings, total shares outstanding   | Companies' annual reports, <a href="http://www.moneycontrol.com">www.moneycontrol.com</a> |
| No. of blockholders (holding >5% equity shares), total shares held by blockholders, etc.                      | Annual reports                                                                            |
| For missing data and other relevant information                                                               | Websites of the companies, yahoo finance India,                                           |

The Datastream calculates the market value capitalization (MVC) as the market price of equity shares multiplied by the number of equity shares outstanding at the end of the fiscal year. The amounts are displayed in millions of units of the local currency, i.e. INR. The sample companies bear 51 per cent of total MVC in 2011, which are 84 per cent in 2012, 70 per cent in 2013, 88 per cent in 2014, and 66 per cent in 2015. I use MVC for each year to arrange the companies in descending order from the highest MVC down to 200th highest MVC of the companies listed on BSE and NSE. Although my initial sample comprised of the 200 largest Indian companies, I had to remove firms from the sample where I could not find the required data for either ownership structure or financial performance. And finally, I obtained the sample size of 149 to 153 largest Indian companies in five years (see Table 5.1).

### **5.3.2. Variables**

#### **5.3.2.1. Independent variables**

Equity shareholdings by institutional investors and promoters, and other ownership related variables, such as family control, promoter directors on boards, non-executive directors' ownership, government ownership, and blockholders' dispersion, are used as independent variables to examine the impact of ownership structures on performance indicators of the 150 largest companies in India. A brief description of these variables follows:

***Institutional ownership (InstOwn)***: As corporate monitors, institutional owners have become increasingly active in CG (Cornett et al., 2007), but not all institutional owners do better monitoring (Maug, 1998). In emerging economies, the controlling shareholders from family or family groups leave fewer incentives to the institutional owners for effective monitoring of the management (Ferreira and Matos, 2008). However, the impact of institutional ownership on firm performance is still unclear. Similar to Ajinkya et al. (2005), and Lin and Fu (2017), '*InsOwn*' is used as the numerical measure that indicates the percentage of company's aggregate equity shares held by institutions.

***Family firm (Family)***: Family ownership and management can reduce or eliminate the classic agency problem I, i.e. the conflict between owners and managers. Instead, it can produce agency problem II, i.e. the conflict between controlling family members and minority shareholders, and can exert a positive/negative effect on firm value (Villalonga and Amit, 2006; Miller et al., 2008). A firm is said to be family owned if a person is a controlling shareholder, that is a person or a group of family members or a family trust (rather than a state, corporation, management trust, or mutual fund) can garner enough shares to assure at least 20 per cent of the voting rights (Kets de Vries, 1993; La Porta et al., 1999; Faccio and Lang, 2002). Family influence and control is more prominent for Indian firms. To examine the impact of family in the business, I construct a binary variable '*Family*' as a proxy for the family-controlled firm, which takes '1' if the firm is family-controlled, and otherwise '0'.

***Promoter and promoter group ownership (PGOwn)***: Promoters' higher share ownership provides insiders sufficient voting power to protect themselves and leads to the entrenchment. Hence, a negative relation between firm value and shareholdings by insiders can be predicted (Navissi and Naiker, 2006). Promoters are an important part of companies in the Indian context, holding a significant percentage of ownership shares, i.e. 59 per cent of equity shares in my sample (see Table 5.3). Promoter shareholding, a proxy for the ownership concentration on founding members, computed as a percentage of total equity ownership of promoter and promoter group in a company as used by Kumar and Singh (2013).

**Promoter directors on board (PDRatio):** In India, as reported by Sarkar (2010), the percentage of companies having promoters as inside directors has been increasing, e.g. 32 per cent in 2003 increased to 47 per cent in 2008. When promoters present as directors, they exercise a significant influence on the board decisions. It implies that the promoters control a large number of Indian companies either by holding a substantial amount of ownership share or serving as the board of directors (Sarkar, 2010). Promoter directors' proportion is the proxy for significant influence and control on the board of directors. I computed the ratio of the number of promoter directors to board size.

**Non-executive directors' ownership (NEDOwn):** In India, non-executive directors include both affiliated outside directors and non-affiliated outside directors (Sarkar et al., 2012). Affiliate outsider directors are non-executive and non-independent directors, also termed as grey directors. These directors have a personal affiliation with the firm and management acting as a professional advisor or consultant, supplier or customer, or previous employee of the company (Clifford and Evans, 1997). These directors are appointed to optimize collaborative working relationships among the members, enabling information flow in the boardroom and reinforcing the board's strategy formulation. Non-executive independent directors are free from personal or economic ties with the firm and its management (Hsu and Wu, 2014). They do not hold any equity shares of the companies; hence, in my model, the NEDs' ownership includes the equity shareholdings of affiliated outside directors. A proxy for the NEDs' ownership I computed the percentage of the total shareholding of these directors on total equity shares outstanding.

**Government-owned companies (Govt. Co.):** Notwithstanding their declining weight in the economy, the Indian government-owned companies constitute a large proportion of industrial activities playing a significant role in driving economic growth (Majumdar, 1998). In my sample, the Govt. Co. includes fully government-owned public enterprises and their subsidiaries (companies having majority ownership shares by the government companies). I matched the names of the Govt. Co., with the names of public enterprises

(PEs), published on PE Survey Reports by the Department of Public Enterprises<sup>44</sup>. Similar to Ramaswamy (2001) and Borisova et al. (2015), I constructed a binary variable '*Govt Co.*' as a proxy for government ownership, which takes '1' if the firm is owned and controlled by the government, and otherwise '0'.

***The number of blockholders (Block):*** Multiple blockholder structures are a widespread phenomenon in India. However, it is unknown whether a single large blockholder or a set of dispersed smaller blockholders is better for firm performance. Also, known as blockholders' dispersion, a numerical measure, '*Block*' indicates the number of individuals or institutions holding at least 5 per cent of equity shares outstanding, which is similarly used by Brockman and Yan (2009), Konijn et al. (2011), and Basu et al. (2016).

#### 5.3.2.2. Control variables

***Firm size:*** Because of the presence of economies of scale, firm size affects performance (Wing and Yiu, 1997). So, I included firm size as a control variable in my regression models. A numerical variable '*FirmSize*' is calculated as the natural logarithm of the book value of the total assets of the firm. A similar approach was used in previous empirical studies, such as Cornett et al. (2007), Bhagat and Bolton (2013), and Lin and Fu (2017).

***Leverage:*** The use of leverage in capital structure may lower agency costs and affect firm performance by disciplining and encouraging managers to perform in the best interests of shareholders rather than indulging in discretionary behaviour (Jensen, 1986; Harris and Raviv, 1991). In contrast, Modigliani and Miller (1958) view that, in a perfect capital market free of taxes, transaction costs and other frictions, the capital structure is irrelevant in determining firm value. But, the Indian capital market is not perfect and not free of taxes and costs. Hence, I take leverage as a controlling variable that affects firm performance. I calculate leverage as the total debt to total capital (Maury, 2006; Bhagat and Bolton, 2013).

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<sup>44</sup> Available at <https://dpe.gov.in/publication/pe-survey/pe-survey-report> (Accessed 30 August 2019).

**Year effects:** Time-varying factors may affect CG efficiency and firm performance. Year effect is taken as a control variable while setting up the panel data.

**Firm-specific effect:** In any sample of listed companies, firm performance is driven, primarily, by industry or firm factors, i.e. some firms may be dominant value creators (leaders), and some may be destroyers (losers) (Hawawini et al., 2003). Firm-specific properties may determine their competitive advantages, CG, and firm performance, so the firm-specific effect is taken as a control variable while setting up the panel data.

### 5.3.2.3. Dependent variables

Three performance variables: market-based performance variable (Tobin's Q) and two accounting based performance variables (return on assets (ROA) and return on equity (ROE)), are used as the dependant variables. They are briefly explained below:

**Tobin's Q:** Tobin's Q, a market-based measure of performance (Adams and Ferreira, 2009), assumes that the replacement values of a firm's assets, i.e. plants, equipment, and inventories, etc., are equal to their book values. Further, Tobin's Q discounts and factors all parameters affecting firm performance (Kumar and Singh, 2012). It is a ratio of a firm's market value to replacement costs of its assets. The firm's market value equals the total value of assets minus the book value of equity, plus the market value of equity (Adams and Ferreira, 2009; Masulis and Mobbs, 2014). This stock-based measure is useful for examining whether minority shareholders account for the potential costs and benefits of ownership structure (Fan et al., 2012). Tobin's Q is considered as the most reliable measure of firm performance in the emerging economies where the accounting standards are not robust (Singh et al., 2018).

$$Tobin's\ Q = \frac{Total\ Assets - Book\ Value\ of\ Equity + Market\ Value\ of\ Equity}{Total\ Assets}$$

Market value of equity is the product of a firm's market price per share and the number of common stock outstanding.

**Return on equity (ROE):** Return on equity is calculated using the following formula:

$$ROE = \frac{\text{Net Income} - \text{Preferred Dividend}}{\text{Average of Last Year's \& Current Year's Common Equity}} \times 100$$

**Return on assets (ROA):** The ‘ROA’ is a measure of the success of a firm in using assets to generate earnings independent of the financing of those assets (Selling and Stickney, 1989).

$$ROA = \frac{[\text{Net Income} + (\text{Interest on Debt} - \text{Interest Capitalized}) (1 - T)]}{\text{Average of Last Year's \& Current Year's Assets}} \times 100$$

### 5.3.3. The model

The following equation is used to capture the relationship between board characteristics and firm performances.

$$y_{it} = a + \beta x_{it} + \varepsilon_{it} \dots\dots\dots(1)$$

Where,  $y_{it}$  = performance variables (i.e. Tobin’s Q, ROA, and ROE);  $x_{it}$  = independent variables (i.e. InstOwn, Family, PGOwn, NEDOwn, PDRatio, Govt, Block, Firm Size, and Leverage);  $\beta$  = regression coefficients of independent variables;  $\varepsilon_{it}$  = residual (error term).

Following is the equation for fixed effect regression model:

$$y_{it} = a + \beta x_{it} + \eta_i + \varepsilon_{it} \dots\dots\dots(2)$$

Where,  $y_{it}$  = performance variables (i.e. Tobin’s Q, ROA, and ROE);  $x_{it}$  = independent variables (i.e. InstOwn, Family, PGOwn, PDRatio, NEDOwn, Govt, Block, FirmSize, and Leverage);  $\beta$  = regression coefficients of independent variables;  $\eta_i$  = fixed effects; and  $\varepsilon_{it}$  = error term.

To obtain consistent and unbiased estimates, I estimate the relation between ownership variables and firm performance using system GMM model as suggested by Arellano and Bond (1991), the dependent variable  $y_{it}$  is generated from a model below:

$$y_{it} = \alpha y_{i(t-1)} + \beta x_{it} + \eta_i + v_{it}, \quad (i = 1, \dots, N; t = 1, \dots, T + 10) \dots\dots\dots(3)$$

Where,  $y_{it}$  = performance variables (Tobin's Q, ROA, and ROE);  $\beta$  = regression coefficients of independent variables;  $\eta_i$  = unobserved fixed effects;  $\nu_{it}$  = residual (error term); and  $T + 10$ , implies that the first 10 cross-sections are discarded so that the actual sample contains  $NT$  observations. For the estimation of  $x_{it}$ , I consider the following equation:

$$x_{it} = \rho x_{i(t-1)} + \varepsilon_{it}, \quad \text{Where, } x_{i(t-1)} = \text{lag of independent variables at } (t - 1).$$

#### 5.3.4. Endogeneity issue

I use panel data analysis which is known as the most efficient tool to use when the sample is a mixture of time series and cross-sectional data. The panel data structure allows to take into account of the unobservable heterogeneity and endogeneity (De Andres and Vallelado, 2008), a situation of having a correlation between the explanatory variables and the error term in a regression (Wintoki et al., 2012; Abdallah et al., 2015; Gippel et al., 2015). This situation commonly arises in empirical research related to CG.

Endogeneity may exist due to the omission of explanatory variables (omitted variable bias), or by the dependent variable being influenced by one or several explanatory variables (simultaneous endogeneity), or by the past realizations of the dependent variables (dynamic endogeneity) (Abdallah et al., 2015; Wintoki et al., 2012). It is difficult to determine whether there is reverse causation (reverse causality, e.g., performance drives ownership) or due to an unobservable factor, which also affects performance (Wintoki et al., 2012). These issues cannot be addressed by OLS estimation as it does not account for the omitted variable inconsistency or omitted variable bias. The fixed-effects estimation, a class of regression method, makes it possible to control for variables that have not or cannot be measured (Allison, 2009). The fixed-effects estimation can potentially mitigate the endogeneity arising from unobservable heterogeneity but ignores the dynamic nature of the governance/performance relation that yields inconsistent estimates (Wintoki et al., 2012). Second, I apply OLS to the dynamic model, including past performance but

temporarily ignoring unobservable endogeneity, i.e.,  $performance = f(past\ performance, firm\ Ownership)$ .

### **5.3.5. System Generalized Method-of-Moments (System GMM)**

A difficulty arises with the fixed effects model in the context of a dynamic panel data mainly in the situations with “small  $T$ , large  $N$ ” panels, meaning few periods and many individuals; independent variables that are not strictly exogenous indicating they correlate to past and possibly current realization of the error; fixed effects; and heteroskedasticity and autocorrelation within individuals but not across them (Roodman, 2009, pp. 86). The application of system generalized method-of-moments (system GMM) estimations, also known as the augmented estimator, seems appropriate as it is an appropriate tool for the panel dataset with the above situations. System GMM shows the importance of dynamics in the analysis of governance performance relationship. Hence, I apply system GMM estimator with fully accounting for fixed effects (unobservable and simultaneous endogeneity) and past performance (dynamic endogeneity), i.e.,  $performance = f(past\ performance, firm\ ownership\ structure, fixed\ effects)$ . According to Wintoki et al. (2012), “The GMM model enables to estimate the governance/performance relation while including both past performance and fixed-effects to account for the dynamic aspects of the governance/performance relation and time-invariant unobservable heterogeneity, respectively” (pp. 596). The system GMM model does not rely on external exogenous instruments rather depends on its own internal instruments within the panel itself based upon lagged values of the explanatory variables included in the regression equation and corrects for three types of endogeneity i.e., omitted variable bias, simultaneous endogeneity, and dynamic endogeneity (O’Connor and Rafferty, 2012; Wintoki et al., 2012).

## **5.4. Empirical Results**

### **5.4.1. Descriptive Statistics**

Descriptive statistics of dependent, independent and control variables, used in my models, are summarized in Table 5.3.

**Table 5. 3: Descriptive statistics**

| Variables | Units of measurement | N   | Minimum  | Maximum    | Mean      | Std. Dev. |
|-----------|----------------------|-----|----------|------------|-----------|-----------|
| MVC       | Million Rs           | 753 | 24704.52 | 5010912.00 | 356153.67 | 565178.00 |
| Tobin's Q | Ratio                | 753 | 0.96     | 10.05      | 3.28      | 2.59      |
| ROE       | Percent              | 753 | 3.51     | 57.61      | 21.59     | 13.75     |
| ROA       | Percent              | 753 | 1.76     | 26.81      | 11.02     | 7.06      |
| InstOwn   | Percent              | 753 | 4.83     | 48.56      | 24.96     | 12.41     |
| PGOwn     | Percent              | 753 | 0.00     | 99.55      | 59.06     | 18.65     |
| NEDOwn    | Percent              | 753 | 0.00     | 8.29       | 0.09      | 0.48      |
| PDRatio   | Ratio                | 753 | 0.00     | 1.00       | 0.30      | 0.22      |
| Block     | Number of            | 753 | 0        | 9          | 2.75      | 1.51      |
| TA        | Million Rs           | 753 | 1426.70  | 5044860.00 | 332957.20 | 560685.87 |
| Firm Size | Natural log          | 753 | 21.08    | 29.25      | 25.52     | 1.47      |
| Leverage  | Percent              | 753 | 0.16     | 76.12      | 30.07     | 25.71     |

Notes: MVC = Market value capitalization in million Rs; Q = Tobin's Q; ROE = Return on Equity; ROA = Return on Assets; InstOwn = percentage of institutional shareholdings on total equity shares outstanding; PGOwn = percentage of promoters and promoter groups' equity shareholdings on total equity shares outstanding; NEDOwn = Percentage of shareholdings of non-promoter and non-executive directors on total equity shares outstanding; PDRatio = Proportion of promoter directors on total number of directors; Block = Number of blockholders holding minimum 5% equity shares outstanding; TA = Total assets expressed in million Rs.; Firm Size = Firm size measured on natural log of total assets of the firms; and Leverage = ratio of total debt/ total capital. Tobin's Q, ROA, ROE and Leverage are winsorized at  $p=0.05$  to reduce the effect of potential outliers.

The average percentage of institutional ownership of large companies in India is approximately 25 per cent which is significantly lower than 45.50 per cent as reported by Velury and Jenkins (2006) for the US firms. The average number of blockholders, in my sample, is found 2.75, which is lower than Basu et al. (2016), i.e. 3.02 in 2009, but slightly higher than Brockman and Yan (2009), i.e. 2.49 in 2001 (both for the US firms). The promoters and promoter groups hold 59 per cent of ownership shares of the sample companies. The promoters hold 30 per cent of board seats, which was 47 per cent in 2008, as reported by Sarkar (2010). In my sample, 50 per cent of the firms are family firms (holding at least 20 per cent of ownership shares of the companies). Sixteen per cent of the sample consists of federal or state government-owned companies.

### 5.4.2. Correlation coefficients

Table 5.5 shows the correlations between the variables of interest. There was a concern over the possibility that the relationship between ownership and performance variables could cause a multicollinearity problem. The correlation coefficients indicate that there are unlikely to have the issues of multicollinearity among independent variables. Also, for the confirmation of non-multicollinearity among them, I computed the variance-inflation factor (VIF) (Table 5.4) for each of the independent variables.

**Table 5. 4: Variance-inflation factors**

| Variable                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | VIF  |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| PGOwn (%)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | 3.92 |
| InstOwn (%)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | 3.65 |
| Govt. Co.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | 2.97 |
| Leverage (%)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | 2.32 |
| PDRatio                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | 2.06 |
| Firm Size                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | 1.76 |
| Family                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | 1.60 |
| Block (No. of Blockholders)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | 1.21 |
| NEDOwn (%)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | 1.05 |
| InstOwn = Percentage of shareholding of institutional investors on total equity shares outstanding;<br>Family = Family firm proxied by 1, if the firm has family ownership and otherwise 0; PGOwn =<br>Percentage of shareholdings of promoters and promoter group on total equity shares outstanding;<br>NEDOwn = Percentage of shareholdings of non-executive and independent directors on total equity<br>shares outstanding; PDRatio = Percentage of promoter directors on board; Govt. Co. = Government<br>company proxied by 1, if the firm is government-owned and otherwise 0; Block = Number of<br>blockholders holding minimum 5% equity shares outstanding; Firm Size = Firm size measured on<br>natural log of total assets of the firms; and Leverage = Ratio of total debt to total capital. |      |

All the variables, as presented in Table 5.4, have VIF less than 5.00; the highest VIF is 3.92 for PGOwn. The commonly accepted threshold of VIF for multicollinearity is more than equal to 10 (Kayhan et al., 2010; Satıcı and Uysal, 2015). Since, all VIF scores are within the acceptable range, indicating that multicollinearity should not be a significant problem among the variables in the regression models.

**Table 5. 5: Correlation coefficients of ownership structure and firm performance**

| SN | Variables                   | 1      | 2      | 3      | 4      | 5      | 6      | 7      | 8      | 9      | 10     | 11    | 12    |
|----|-----------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|-------|-------|
| 1  | Tobin's Q                   | 1.000  |        |        |        |        |        |        |        |        |        |       |       |
| 2  | ROA (%)                     | 0.680  | 1.000  |        |        |        |        |        |        |        |        |       |       |
| 3  | ROE (%)                     | 0.567  | 0.774  | 1.000  |        |        |        |        |        |        |        |       |       |
| 4  | InstOwn (%)                 | -0.013 | 0.046  | -0.003 | 1.000  |        |        |        |        |        |        |       |       |
| 5  | Family                      | -0.045 | 0.008  | -0.027 | 0.133  | 1.000  |        |        |        |        |        |       |       |
| 6  | PGOwn (%)                   | 0.022  | -0.018 | 0.004  | -0.348 | -0.176 | 1.000  |        |        |        |        |       |       |
| 7  | NEDOwn (%)                  | 0.036  | 0.048  | 0.024  | 0.088  | 0.132  | -0.117 | 1.000  |        |        |        |       |       |
| 8  | PDRatio                     | -0.063 | 0.028  | 0.006  | -0.236 | -0.127 | 0.308  | -0.029 | 1.000  |        |        |       |       |
| 9  | Block (No. of blockholders) | 0.041  | -0.039 | -0.036 | 0.139  | 0.359  | -0.197 | 0.027  | -0.077 | 1.000  |        |       |       |
| 10 | Govt. Co.                   | -0.258 | -0.132 | -0.134 | -0.262 | -0.446 | 0.354  | -0.080 | 0.648  | -0.272 | 1.000  |       |       |
| 11 | Firm Size                   | -0.634 | -0.441 | -0.363 | 0.103  | -0.069 | -0.076 | -0.130 | -0.014 | -0.108 | 0.304  | 1.000 |       |
| 12 | Leverage (%)                | -0.511 | -0.601 | -0.268 | -0.006 | 0.208  | -0.044 | -0.042 | -0.052 | 0.086  | -0.005 | 0.450 | 1.000 |

ROE = Return on Equity; ROA = Return on Assets; InstOwn = Percentage of shareholding of institutional investors on total equity shares outstanding; Family = Family firm proxied by 1, if the firm has family ownership and otherwise 0; PGOwn = Percentage of shareholdings of promoters and promoter group on total equity shares outstanding; NEDOwn = Percentage of shareholdings of non-executive and independent directors on total equity shares outstanding; PDRatio = Percentage of promoter directors on board; Govt. Co. = Government company proxied by 1, if the firm is government owned and otherwise 0; Block = Number of blockholders holding minimum 5% equity shares outstanding; Firm Size = Firm size measured on natural log of total assets of the firms; and Leverage = Ratio of total debt to total capital. Tobin's Q, ROA, ROE, InstOwn, and leverage are winsorized at p=0.05 to reduce the effect of potential outliers; \*\*\*, \*\*, \* significant at 0.01, 0.05 and 0.10 levels, respectively.

### 5.4.3. Regression results

The following Table 5.6 presents the regression results from system GMM estimations.

**Table 5. 6: System GMM estimations for ownership structure and firm performance**

| Variables                  | Tobin's Q           | ROA                    | ROE                      |
|----------------------------|---------------------|------------------------|--------------------------|
|                            | coef/se             | coef/se                | coef/se                  |
| Tobin's $Q_{t-1}$          | 0.345**<br>(0.150)  |                        |                          |
| $ROA_{t-1}$                |                     | 0.557***<br>(0.098)    |                          |
| $ROE_{t-1}$                |                     |                        | 0.214**<br>(0.104)       |
| InstOwn. (%)               | 20.046*<br>(10.990) | -0.595<br>(12.889)     | 0.708<br>(18.971)        |
| Family (proxy Y=1; N=0)    | -1.766<br>(1.377)   | 4.752**<br>(2.245)     | 16.629*<br>(9.406)       |
| PGOwn (%)                  | 18.355*<br>(9.366)  | -3.529<br>(10.454)     | -4.862<br>(16.051)       |
| NEDOwn (%)                 | 51.168<br>(59.624)  | -312.779*<br>(179.016) | -1112.887**<br>(502.564) |
| PDRatio (Ratio)            | 1.725<br>(2.559)    | -0.051<br>(4.400)      | 18.029<br>(15.752)       |
| Block (No.)                | 0.865*<br>(0.492)   | -0.579*<br>(0.309)     | -3.579**<br>(1.544)      |
| Govt. Co. (proxy Y=1; N=0) | -4.226<br>(3.036)   | 2.070<br>(4.113)       | -10.879<br>(17.566)      |
| Firm Size (Log)            | -0.858**<br>(0.494) | -1.598**<br>(0.772)    | -9.707**<br>(4.111)      |
| Leverage (Ratio)           | -0.010<br>(0.021)   | -0.076***<br>(0.028)   | 0.032<br>(0.181)         |
| Number of observations     | 544                 | 544                    | 544                      |
| Wald Chi2                  | 117.21              | 250.74                 | 30.77                    |
| Hansen Test- p-value       | 0.062               | 0.109                  | 0.110                    |
| AR1                        | 0.002               | 0.022                  | 0.017                    |
| AR2                        | 0.475               | 0.325                  | 0.380                    |
| Year Effect                | Yes                 | Yes                    | Yes                      |
| Firm Specific Effect       | Yes                 | Yes                    | Yes                      |

Tobin's  $Q_{t-1}$  = One year's lag of Tobin's Q; ROE = Return on Equity;  $ROE_{t-1}$  = one year's lag of ROE; ROA = Return on Assets;  $ROA_{t-1}$  = One year's lag of ROA; InstOwn = Percentage of shareholding of institutional investors on total equity shares outstanding; Family = Family firm proxied by 1, if the firm has family ownership and otherwise 0; PGOwn = Percentage of shareholdings of promoters and promoter group on total equity shares outstanding; NEDOwn = Percentage of shareholdings of non-executive and independent directors on total equity shares outstanding; PDRatio = Percentage of promoter directors on board; Govt. Co. = Government company proxied by 1, if the firm is government owned and otherwise 0; Block = Number of blockholders holding minimum 5% equity shares outstanding; Firm Size = Firm size measured on natural log of total assets of the firms; and Leverage = Ratio of total debt to total capital. Tobin's Q, ROA, ROE, InstOwn, and leverage are winsorized at p=0.05 to reduce the effect of potential outliers; \*\*\*, \*\*, \* significant at 0.01, 0.05 and 0.10 levels, respectively. Standard errors are in parentheses.

The above table (Table 5.6) shows regression coefficients for firm performance, Tobin's Q, ROA, and ROE, as dependent variables and firm ownership and control variables as independent variables.

The regression model for Tobin's Q uses past year's Tobin's Q as measured by one-year lag value as a predetermined endogenous variable along with Leverage, Firm Size, NEDown, and PDRatio as internal instrumental variables. The table shows that the regression coefficients for Tobin's Q on dependent variables, TobinsQt-1, InstOwn, PGOwn, and Block are positive and statistically significant at 5%, 10%, 10%, and 10% levels of significance, respectively. Similarly, the regression coefficient of Firm Size is negative and statistically significant at 5% level of significance. The regression coefficients for Family, NEDown, PDRatio, Govt. Co., and Leverage are not statistically significant.

My regression model, showing an association of ROA with ownership variables, uses ROAt-1, Firm Size, Leverage, and NEDown as predetermined endogenous variables with PDRatio, Block, and InstOwn as the internal instrumental variables. The regression coefficients of ROA on independent variables ROAt-1 and Family are positive and statistically significant at 1% and 5% levels of significance, respectively. The regression coefficient of ROA on NEDown, Block, Firm, Size, and Leverage are negative and statistically significant at 10%, 10%, 5% and 1% levels of significance, respectively. The regression coefficients of InstOwn, PGOwn, PDRatio, and Govt. Co. are statistically insignificant.

Similarly, in the regression model for return on equity (ROE), I use ROEt-1, Firm Size, Leverage, and NEDown as the predetermined endogenous variables and PDRatio, PGOwn, Block, and InstOwn as the internal instrumental variables. The regression coefficients of ROE on ROEt-1 and Family are positive and statistically significant at 5% and 10% levels of significance, respectively. Whereas, the regression coefficients of NEDown, Block, and Firm Size are negative and statistically significant at 5%. Regression results of InstOwn, PGOwn, PDRatio, Govt. Co., and Leverage are found statistically insignificant.

#### 5.4.4. Robustness Checks

I performed several robustness checks to increase confidence in capturing the impact of ownership structure on firm performance. I computed variance inflation factors (VIF) to confirm non-multicollinearity among the variables and found all independent variables of the models are within the threshold level of acceptance, i.e. below 10 (Table 5.4). I performed Hansen tests for overriding effects. Hansen test legitimises the instrumental variable sets at a 0.05 significant level (Blundell and Bond, 2000; Ghartey, 1998). In the regression models<sup>45</sup>, all the p-values of the Hansen Test statistics are above 0.05; hence, the instruments selected for the models are legitimised. Wald  $\chi^2$  test statistics are computed to check the fit of the model and to ensure that the instruments are strong. All the Wald  $\chi^2$  test statistics are significant, which indicate that the variables create statistically significant improvement in the fit of the models. Also, I performed Arellano-Bond tests, AR(1) and AR(2) to check whether there is a serial autocorrelation among the variables in the models. The test statistics for AR(1) and AR(2) show that the regression models have no second-order autocorrelation and hence, further modifications of the models are not required. I believe that the regression models used to analyse the data and the results obtained are robust.

### 5.5. Discussion

According to the agency theory, due to the separation of ownership and control mechanisms of modern companies, the companies' ownership structure determines the agency problems and agency costs and ultimately affects the performance indicators (Jensen and Meckling, 1976, Berle and Means, 1932). Based on this notion, I asked whether the ownership structure has any impact on firm performance. The results suggest that the ownership structure indeed affects the firm performance in one of the largest emerging economies, India. However, the relationship between individual variables of ownership structure and firm performance are found somewhat different

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<sup>45</sup> See Table 5.6 for Hansen Test, Wald  $\chi^2$ , and Arellano-Bond Test [AR(1) & AR(2)] results in the regression models.

than the findings from the existing literature in this field. The results are discussed below, linking to the hypotheses:

The association of institutional ownership with firm performance, as measured by Tobin's Q, is positive and significant. But it is not significant with ROA and ROE. Based on the association of institutional ownership with market performance, I agree with hypothesis 1, i.e. institutional ownership is positively associated with the performance of Indian companies. This positive association is consistent with the findings of Gompers and Metrick (2001) and Navissi and Naiker (2006). It suggests that the potential investors in the market take the presence of institutional investors as a positive signal for minimizing agency costs because institutional investors have the opportunity, resources, and ability to monitor and discipline, and influence managers for better firm performance.

However, an insignificant association of institutional ownership with accounting performance (ROA and ROE) suggests that institutional ownership does not affect the accounting performance of the large companies in India. This finding does not support the agency theory which postulates that the corporate monitoring by institutional investors can result in managers focusing more on corporate performance and less on opportunistic or self-serving behaviour. This finding does not corroborate with the conclusions from Cornett et al. (2007), Elyasiani and Jia (2010), Boone and White (2015), all for US firms, and Dong and Ozkan (2008), for UK firms, who report a positive and significant association between institutional ownership and performance indicators. This unique evidence suggests that institutional investors may have business relations with local companies in which they invest, maybe loyal to the management, and compromise their roles as monitors (Aggarwal et al., 2011). In India, the listed companies have a large number of controlling shareholders from family or family groups. In this unique context, my findings agree with the conclusions of Maug (1998) and Ferrera and Matos (2008) that the controlling shareholders leave fewer incentives to the institutional investors for effective monitoring of the management. Hence, institutional investors in emerging economies fail to deliver any significant impact on firm performance.

The regression coefficients of the variables, that measure the relationship of family firms and firms' accounting performance, ROA and ROE, are positive and statistically significant, suggesting to agree with Hypothesis 2. The family ownership and control in business produces a significant impact on firm performance in India, especially in utilizing resources and maximizing returns to the equity holders. This finding supports the postulation made by agency theory, as described by Fleming et al. (2005), that agency cost is minimized or mitigated in the owner-managed or family-managed firms. My findings agree with Chu (2011), for Taiwanese firms, and Minichilli et al. (2016), for Italian firms, who find a positive association between family ownership and performance indicators. Similar to my results, Anderson and Reeb (2003), in the US S&P 500 firms, report that the family ties in business are associated with increased performance. Similar to Ashwin et al. (2015) for the Indian pharmaceutical industry, my findings support the stewardship theory, which predicts that families in business are the strong stewards. They effectively monitor managerial activities, perform as the custodian of business properties, and bring positive influence on firm performance indicators. However, my findings do not corroborate with Bhaumik et al. (2010), who report a negative impact of family ownership on the performance of companies in pharmaceutical and automotive sectors in India.

In contrast, the association of the family in business with Tobin's Q is not significant. This result agrees with Holderness and Sheehan (1988) and Miller et al. (2007), both for the US companies, who find no evidence of the superior market performance of family firms. My results for Tobin's Q, ROA, and ROE imply that, on the one side, the family in business has no impact on the market performance. In such a situation, the minority owners of the companies are not better off from company performance. However, on the other side, family ownership is enhancing accounting profitability of the firms. These findings point that the market perceives, the family owners, as the controlling shareholders, have potentials to expropriate company profits for private benefits. But, in fact, as the controlling shareholders family members are the effective monitors of the managerial activities and are effective in mitigating or minimizing agency conflicts and enhancing firm performance (accounting performance).

The regression analysis, for the association of promoter's ownership with firm performance, provides a mixed result. On the one hand, the regression coefficient of Tobin's Q on promoters' ownership is positive and significant. This finding for (Q) suggests agreeing with hypothesis 3(a), corroborates with Kumar and Singh (2013), who document a positive relationship between promoter's ownership and Tobin's Q. Promoters are the founder owners of the company, and their ownership concentration provides potential investors, a positive company image. They believe that the promoters have enough incentive and control to monitor managers and enhance firm value. However, on the other hand, the regression results for the effect of promoters' ownership on ROA and ROE are not significant, suggesting to disagree with hypothesis 3(a) for ROA and ROE. This finding supports the findings of Ghosh (2010), who reports no significant association between promoters' equity ownership and accounting performance indicators in India.

These inconsistent results of family ownership and promoter groups' ownership (hypotheses 2 and 3(a)) with firm performance may be due to some stringent CG rules, such as the requirement of corporate disclosure, and independence of the boards and board committees. These rules curtailed the power of controlling owners (promoter groups and families) and pushed them into the minority positions in strategic decision making. In overall, these mixed results about the association of ownership concentration on promoter groups and families with performance indicators, do not help me to recommend for further amendments in CG mechanisms.

Similarly, based on the regression results for the association between the proportion of promoter directors on boards and all performance indicators, I cannot entirely agree with hypothesis 3(b) that by having a higher or lower proportion of promoters on companies' boards have no significant association with performance indicators. In the sample, the ownership pattern of companies shows that the promoters own high cash flow rights but assume low control rights by pushing them in to the minority of the boards of directors. Promoter directors are the inside directors with superior firm-specific knowledge to effectively oversee firm operations and investment activities (Masulis and Mobbs, 2011). However, being in the minority, they are unable to provide valuable inputs to board deliberations regarding managerial activities and enhance firm

performance. Being in minority position, the promoters have no influence in minimizing or mitigating agency conflicts arising between owners and management.

Next, I agree with hypothesis 3(c), for accounting performance, that the equity ownership of non-executive and non-promoter directors significantly affects ROA and ROE; however, such an effect is negative. In my sample, the NEDs' ownership refers only to the equity shareholdings of affiliated outside directors (grey directors). According to the Companies Act 2013 and equity listing rules, independent directors do not hold any equity shares of listed companies in India. My finding is in line with Boyd (1996), for the US firms, who reports a negative association of non-executive director shareholdings with firm profitability. Similarly, the association of NEDs' ownership with Tobin's Q is not statistically significant. These findings show that NEDs' equity ownership is either negatively associated or is neutral in affecting firm performance. NEDs hold a tiny fraction of total equity shares outstanding. They are part-time directors with no executive roles, and they perform only the advisory roles and thus, have a minimum commitment to the companies. NEDs' equity shareholdings are not enough to bring any positive impact on firm performance; instead, they are negatively affecting performance indicators. In the present ownership scenario of NEDs of listed companies in India, the equity shareholding is not enough to motivate NEDs in minimizing agency problems, which is against the postulation of agency theory.

The regression results provide no qualified evidence to agree with hypothesis 4 that government ownership and control is not associated with the firm performance of listed companies in India. The regression coefficients for all measures of firm performance, i.e. Tobin's Q, ROA, and ROE on Govt. Co., are not statistically significant. These findings show that state-ownership is not an important determinant of firm performance of SOEs in India. These findings do not entirely agree with Ramaswamy (2001), Majumdar (1998), and Ahuja and Majumdar (1998), who find that government ownership is resulting in a negative impact on performance indicators. The findings also do not agree with Wang and Yung (2011), for the state-owned enterprises in China, who document a better firm performance in terms of earnings quality. They further contend the notion that the state-ownership is not the root cause of all sorts of corporate inefficiency. However, I can infer that the inability of state-ownership in positively and

significantly affecting firm performance partially supports the core concept of agency theory, as suggested by Shleifer and Vishny (1997), that inefficiencies of SOEs is a natural outcome of the absence of ownership incentives for firm managers, due to the separation of ownership (public) and control (politicians).

There are some possible reasons as to why state-ownerships of companies in India are failed to have significant impacts on their market and accounting performance indicators. Majority of the state-owned enterprises do not operate at the optimal capacity that indicates the existence of scale inefficiencies, excessive levels of employees, hindrances in reform and restructuring of SOEs by employees and trade unions (Thakur et al., 2006). Majumdar (1998a) note that SOEs provide a few choices and incentives to management to enhance economic performance. Most companies' decisions, such as location and technology choices, product mixes, and marketing arrangements, are made for political considerations but not based on economic criteria. Another critical reason for inefficiency and underperformance of SOEs in India is likely to be of their weak CG mechanisms. They are operating in a highly competitive environment and facing immense challenges of accountability, and weak internal controls and oversight marring CG practices (Mishra, 2014). Majumdar (1998a) further argue that appointments on the boards of directors are made from senior bureaucrats or politicians often based on political patronage than of merits resulting poor board oversights.

The number of blockholders has a mixed effect on performance indicators. The regression results for Tobin's Q suggest agreeing with hypothesis 5 that the number of blockholders is positively related to market performance. This result is different from Konjin et al. (2011), for the US firms, who report a consistently negative association between the presence of blockholders, their numbers, and Tobin's Q. In India, the potential investors in the market take multiple blockholders as a positive gesture for effective monitoring. Blockholders may provide a monitoring function that reduces agency costs and increases market performance.

Similarly, while regressed for the association of ROA and ROE with the number of blockholders, it provides a negative result, suggesting agreeing with hypothesis 5 that

the presence of multiple blockholders negatively affects the accounting performance. This finding for India is contrary to Wright et al. (1996) for the US firms and Thomsen et al. (2006) for Continental Europe. This result also does not support the arguments of Heflin and Shaw (2000) that blockholders have an equal chance to have access to private, value relevant information via their roles as monitors of firms' operations. Based on the findings for both market and accounting performance indicators, I can infer that the presence of multiple blockholders' has positive effects on potential investors and improve market performance. However, on the other hand, a higher number of blockholders adversely affects firms' efficiency in assets mobilization as well as diminishes shareholders' returns. My findings for the presence of multiple blockholders is in line with the postulation of agency theory that multiple blockholders may worsen CG by fueling agency conflicts among number of blockholders, extracting private benefits of control or pursuing objectives other than optimization of firms' resources and maximization of shareholders returns.

The System GMM estimation uses lag of past performance to account for dynamic effects of past performance on current performance. The lag values of performance measures have a positive and significant association with current years' firm performance, which implies that there is the presence of dynamic effects of past performance on firm performance. Also, the regression coefficients of control variables demonstrate a mixed relationship with firm performance. Larger firms are less profitable and have a negative association with all measures of firm performance. Similarly, leverage is positive with ROA but not associated with Tobin's Q and ROE.

***Impact of regulatory shifts on ownership and firm value:*** During my sample period, corporate India has witnessed significant regulatory shifts, i.e. changing the CG landscape from the principle-based approach to the rule-based approach. Until the issuance of Companies Act 2013, most of the CG rules in India were voluntary similar to the UK' comply or explain' approach, also known as the business approach or principle-based approach of CG. However, the Companies Act 2013 has incorporated most of the CG requirements as the hard law, mandatory to all listed companies, similar to the US SOX 2002, which is also known as rule-based approach.

The Companies Act 2013 allows the cross-border mergers and acquisitions of Indian companies with foreign companies with prior approval of the central government. This provision can provide opportunities to the Indian companies for their global presence. The Act is making ease in setting-up and winding-up of the companies which may attract more investors from around the world. The Act acknowledges the concept of shareholder democracy by protecting shareholder rights and providing special considerations to small shareholders. The Act introduces a new concept of class action suits which can be initiated by shareholders against the company and auditors, which protects shareholders interests. These provisions, directly or indirectly, may bring changes in the ownership patterns of listed companies, and also on their performance.

However, I am unable to do the partitioning of the data before and after the issuance of Companies Act because my sample period covers only one year's observations from the full enactment of the law. Hence, in this study, I am unable to perform regression analysis and make any firm inference about the impact of such regulatory shift in examining the association of ownership structure and firm performance in India.

## **5.6. Summary and Conclusions**

This paper provides evidence on the relationship between firm ownership variables and three widely used performance indicators, Tobin's Q, ROA, and ROE. Tobin's Q focuses on firms' market performance, while ROA and ROE focus on the firms' accounting performance. Several ownership variables, such as institutional, promoters' and non-executive directors' ownerships and other ownership related variables, such as family control, the proportion of promoter directors, number of blockholders (blockholders' dispersion), and government-owned companies, are regressed to examine the association of ownership structures with performance indicators. The paper uses a sample of the largest Indian companies, listed on the Bombay Stock Exchange and the National Stock Exchange. While doing so, I controlled the impact of firm size, leverage, time-variant effects, and industry effects.

This investigation unfolds some unique findings, in terms of the association of institutional ownership, family ownership and control, promoters' ownership,

government-owned companies, and blockholders' dispersion with firm performance, for the extension of existing literature from the Indian context. The investigation finds a significant positive association of institutional ownership with firms' market performance but finds no significant association with firms' accounting performance. These findings suggest that the presence of institutional investors gives a positive signal to potential investors in the market. However, they are unable to optimize the usage of firm resources and enhance returns to the shareholders. In emerging economies like India, it is still unclear whether there is any impact of institutional investors, in terms of their numbers, origin, and level of activism, on firm performance.

I suggest for future research to examine the role and performance implications of institutional investors by splitting them into foreign and domestic institutional investors. Aggrawal et al. (2011) argue that foreign institutional investors may bring prompt changes in CG by importing new resources (technology and practices), which may affect firm value. Domestic institutional investors may have business relations with the local companies and show loyalty to the management, encourage for managerial entrenchment, and adversely affect firm value. Similarly, the number of institutional investors may affect firm performance because of the level of interaction and collaboration in monitoring the management (Cornett et al., 2007). The activist behaviour of institutional investors, such as voting proxies to counter management positions, filing shareholder proposals and initiating frequent contact with management, attempt to directly affect the outcomes of strategic direction and performance or indirectly influence them through refinements to CG (Ryan and Schneider, 2002).

Family association in business is universal and seems economically significant as it positively affects firms' accounting performance, but they are unable to give any impact on market performance. Similarly, the promoters' ownership and their proportions on board composition do not affect firms' accounting performance. The impact of blockholders' dispersion on accounting performance measures is negative, but it is positive with the market performance. Some stringent CG mechanisms, such as the requirement of corporate disclosure, independence of boards and board committees, have curtailed the power of controlling owners (promoter groups and families). Future works can examine the issues, such as: Does the proportionate board appointment hurt

the minority interest? How does the separation of cash flow rights and control rights benefit to the large owners from families and promoters?

The ownership of affiliated outside directors as proxied by non-promoter and non-executive directors are hurting firm performance. Neither these classes of directors are independent, nor does their equity ownership have positive impacts on firm performance. Hence, they need to redefine the role of affiliated NEDs, and their appointment on the corporate boards needs to be curtailed down. Further inquiry is needed on this issue. Similarly, government involvement in a business does not impact either to the value creation or value destruction activities of the SOEs. Although the SOEs are playing important roles in India's economic development by filling up the entrepreneurial void in the corporate sector and paving ways for private sector investments. From an economic perspective, my analysis shows that these enterprises are unable to demonstrate economic efficiency in terms of financial performance. Hence, further investigation is needed to advise for alternative ownership arrangements of SOEs in India.

In reality, the relationship between ownership structure and firm performance, as indicated by my analysis, is not straightforward; instead, it is more complicated than was previously thought. In some cases, the association of ownership variables with market performance are positive but are negative with accounting performance and vice versa, making it difficult to make a precise inference. While reading this paper, the reader should give adequate cautions that this study involves a sample of the largest companies in India, and hence the scope of generalization of the evidence can be limited to this category.

The results of this paper are important in understanding the effects of a firm's ownership structure on performance in an economy where there is limited evidence available. This paper will motivate researchers for further study on ownership structure, CG and firm performance, taking a wider population of listed companies in India. Also, this is imperative to promote evidence-based practices and policies in light of the increasing flows of foreign direct investment and portfolio investment to India. Comparative studies are also warranted on ownership structure, CG and firm

performance between the companies with foreign portfolio investment and domestic investment.

This study is unable to provide any inference about the impact of changes in the CG laws from the principle-based approach to rule-based approach on ownership structure and firm performance. My sample does not provide enough observations to perform this natural experiment. However, it provides the basis for future research considering the effects of the contemporary regulatory reforms, such as the Companies Act 2013 and IBC 2016, on ownership structure and firm performance.

## 5.7. References

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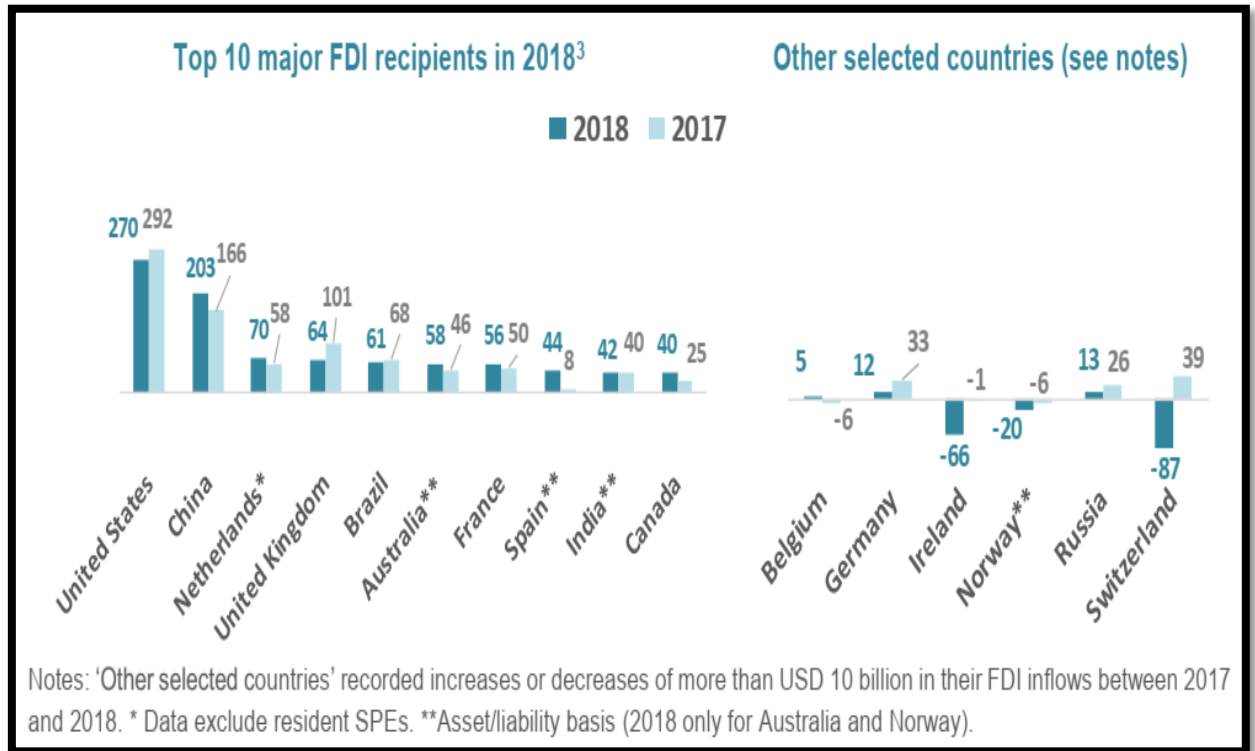
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## Appendix 5A.

### I. FDI inflows of selected countries, 2017-2018 (USD billion)



Source: OECD International Direct Investment Statistics Database

### II. FDI inflows in India and percentage of GDP (USD billion)

| Year        | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|-------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| FDI inflows | 7.6  | 20.3 | 25.5 | 47.5 | 35.6 | 27.4 | 36.5 | 24.0 | 28.2 | 34.6 | 44.0 | 44.5 | 40.0 | 42.2 |
| % of GDP    | 6    | 8    | 9    | 10   | 13   | 12   | 11   | 12   | 12   | 13   | 13   | 14   | 15   | N/A  |

Source: OECD International Direct Investment Statistics Database

## **Chapter 6: Contributions, Limitations and Directions for Future Research**

People often question whether CG matters because their day-to-day impact is difficult to observe (Adams et al., 2010). There has been a proliferation of studies to resolve this issue particularly in the developed economies where CG problems tend to have their roots in widely dispersed corporate ownership, small managerial shareholdings, the prevalence of standalone companies, and market-based transactions (Armitage et al., 2017). However, little works have been done in the context of emerging economies. The nature of CG problems in emerging economies are unique than those of the developed economies; mainly they are rooted in concentrated ownership, pyramidal ownership structures, the dominance of family and business groups, and high levels of related-party transactions resulting principal-principal conflicts (Young et al., 2008). This thesis investigates CG systems and practices in one of the largest emerging economies, India. The overall objective of this thesis is to analyse the CG systems in India and to examine the relationship of firm-level CG practices with financial performance indicators in a sample of Indian listed companies. This section includes the contributions made by the thesis, limitations and directions for future research.

### **6.1. Contributions of the papers**

This thesis includes three papers, which covers the various aspects of CG in India. It employs different theories to guide the studies and covers the internal governance environment of listed companies in India. The followings are its contributions:

#### **6.1.1. Corporate governance in India and a comparison with the USA and UK (Paper 1)**

The first paper, entitled ‘Corporate governance in India and a comparison with the USA and UK’, is an analytical and a comparative piece of work. The first part of the paper describes the CG scenario in India, and the next part compares and contrasts the Indian CG systems with the USA and UK. The contributions of this paper are:

- a) Providing knowledge on the evolving perspective of CG in an emerging economy, India, including historical background for CG reform and efforts made for the gradual evolution of CG systems in the country;
- b) Analysing laws, regulations and codes relevant to the CG of listed companies in India. Companies' boards, management and other stakeholders may find how these CG laws, rules and codes do affect them directly or indirectly;
- c) Disclosing convergence and divergence of Indian CG practices by comparing them with the USA and UK practices.

In most of the comparative CG studies, the researchers take the USA and UK CG systems as an international benchmark. The paper provides evidence that many aspects of CG systems in India are changing and are beginning to look alike with the USA and UK systems. One can view this convergence as the adoption of the best practices of the existing governance systems. For example, India issued a new Companies Act 2013, changing most of the CG rules as hard laws to discipline the board of directors and managerial persons, which principally resembles the US Sarbanes-Oxley Act 2002. The provision of board leadership style, board independence, board committees, accounting, auditing and disclosure requirements are principally converged to the USA and UK practices.

The paper also provides some notable divergence in Indian CG systems from the USA and UK, resulting from the differences in legal, financial and cultural factors. Notwithstanding the convergence in principle, Indian CG Systems neither fully converges to, nor diverges entirely from the Anglo-American CG systems. Instead, India has been selectively adopting features from the USA and UK CG systems, decoupling them from the original context, and tailoring them to fit her local contexts to gain legitimacy and achieve efficiency in firm-level. For example, the mandatory quota for women director, directors' age limit, tenure and independence, and accounting, auditing and disclosures systems have been carefully tailored to meet the needs of the Indian context. To the best of my knowledge, this type of comparative study has never been done before. The global investors may find such comparison useful in valuing companies while making their investment decisions. The paper also can be a basis for international comparisons among developed, emerging and other economies.

### **6.1.2. Board characteristics and firm performance: Evidence from India (Paper 2)**

Board of directors is an integral part of the governance structure of modern corporations; hence, they remained in the epicentre of CG reform (Vafeas and Theodorou, 1998). In India, too, the governance-related laws, regulations, and codes consider the characteristics of the board of directors as the critical determinants of CG structure and firm performance. Paper 2 of this thesis examines the board characteristics of Indian listed companies linking them with performance indicators, in light of the CG guidelines set by the Corporate Governance Voluntary Guidelines 2009. Board characteristics include - board composition, size, busyness and leadership structure, directors' age, tenure and remuneration, and board activities. The contributions of this paper are: a) expanding the theoretical understanding of the relationships between board characteristics and firm performance, using multiple theories, such as of agency, stewardship, and resource-dependency, which recognize the various roles performed by the board of directors; and b) providing empirical evidence from an emerging economy, India, particularly in the context of changing CG regulations, i.e. the Corporate Governance Voluntary Guidelines 2009, and unique institutional contexts.

There is a proliferation of studies related to the board of directors in developed economies, but the generalization of their findings to other economies are limited because of divergence in the institutional settings of other economies. However, little works have been done in the context of emerging and developing economies, particularly of India. Some studies are found in India, for example, Ghosh, A. (2006) for structure of board compensation; Balasubramanian et al. (2010) for preparing CG index in India, Kumar & Singh (2013) for the effect of board size on firm value; Jackling and Johl (2009) for the relationship of board structure on firm performance of India's top companies; Sarkar & Sarkar (2009) impact of multiple directorships on firm performance; and Jameson et al. (2014) for the effect of board structure on firm value. This paper extends the findings of the above literature on board characteristics of Indian companies, such as the board size, independence, busyness and compensation by examining their relationship with firm performance. This paper also provides new evidence on the impact of directors' age and tenure, boardroom gender diversity, and board activities on firm performance, which were not extensively covered from India

before. This evidence can have policy implications for the amendment of CG rules relating to board composition, qualifications, and diversity.

### **6.1.3. Ownership structure and firm performance: Evidence from India (Paper 3)**

Paper 3 examines the impact of ownership structures on firm performance of listed companies in India. The study is important in the Indian context because the ownership structure of the Indian companies has been changing with the increase in FDI and FPI flows. India stands as one of the attractive investment destinations among global investors. In this regards, the paper has made a couple of contributions.

First, in the CG literature, it expands current notions of monitoring effectiveness through ownership structure in an emerging market context, which is less explored and ignored. The paper extends the existing literature for the Indian context, such as Pant and Pattanayak (2010), impact of competition intensity on ownership and productivity of Indian companies; Jameson et al. (2014), impact of family, as controlling shareholders, on firm performance; Lodh et al. (2014), impact of family ownership on innovation; Kumar and Singh (2013), association of promoter ownership with corporate performance; Ramaswamy (2001), comparing private and state-owned companies to examine competitive intensity and firm performance; and Ahuja and Majumdar (1998), investigating manufacturing SOEs for their efficiency in resource utilization and performance.

Second, the paper provides new pieces of evidence in terms of the proportion of promoter directors on board, equity ownership of non-executive directors, institutional ownership, and the number of blockholdings and their impacts on firm performance of listed companies in India. These findings are distinct than the evidence from developed and other emerging economies. Although higher ownership by institutional investors and promoters are taken positively by the market participants, they are not making a significant contribution to the firm performance. Their intense monitoring benefits do not outweigh the relative costs of monitoring (Almazan et al., 2005). Presence of multiple blockholders hurts firm performance because it limits the ability of smaller blockholders to challenge the largest blockholders, and there exists a lack of

coordination in monitoring management (Konjin et al., 2011). Family ownership and control is useful in enhancing firm profitability. Likewise, government-owned firms have no association with firm performance.

## **6.2. Limitations of the studies**

Although the results of this thesis are important, they must be interpreted in light of the following limitations, which may be addressed in future research.

First, a clear limitation of my study is that it does not cover all internal and external CG variables. A complete package of firm-level CG mechanisms may require a good balance between Internal and external governance mechanisms (Agrawal and Knoeber, 1996). Internal mechanisms include the board of directors, ownership structure and roles of executive managers and their incentives (Fama and Jensen, 1983). External mechanisms include the CG laws, rules and regulations, financial and capital markets, market for managers, and the market for products and services (Cuervo, 2002). Examining governance mechanisms in a univariate context may not be an effective way of studying CG issues (Coles et al., 2001).

Second, I use a limited number of explanatory and control variables. Paper 2 covers board characteristics variables, such as board size, leadership style, busyness and independence, directors' tenure, age and compensation, and boardroom gender diversity. Other variables, such as firm age, directors' qualifications and ethnicity, board committee structure, and activism, are not covered in the paper. Paper 3 includes firm ownership variables such as equity ownership of institutional investors, promoters and non-executive directors, family control, proportion of promoter directors on boards, government ownership and control, and no. of blockholders. The paper does not cover other ownership variables, such as the size and type (short or long-term) of institutional investors, separate variables for domestic and foreign institutional investors, institutional investors' activism, group affiliation, and firm age.

Third, the sample comprised of the cross-sectional panel data of listed companies from 14 different industry classifications. While constructing the panel data, I assumed that

the model parameters are stable across industries and over time by controlling industry-specific and time-variant effects. However, the cross-sectional methodology does not adequately account for variation in model parameters across firms (Bowen and Wiserema, 1999). Hence, a common limitation of Paper 2 and 3 is that their cross-sectional nature of data implies that conclusions must be viewed as being tentative at best. Caution is needed while generalizing the findings of exploratory studies of this nature.

Fourth, the sample size consists of the largest 149 - 155 companies in India, listed on BSE and NSE. The largest companies, because of their resource access and reach into international markets, may have a higher rate of compliance. Small and medium-sized companies may be vulnerable in this regard. There is an obvious difference in governance between small and large firms (Cowling, 2003; Black et al., 2006). Hence, the selection of sample size, sample periods, and firm size is another limitation of the papers and a proper caution should be required while reading their findings.

Fifth, following the suggestions of Abdallah et al. (2015), O'Connor and Rafferty (2012), and Wintoki et al. (2012), I use system GMM estimation techniques that would mitigate the effects all forms of endogeneity including omitted variable bias. However, other estimation techniques, such as instrumental variables, two-steps least squares, and three-steps least squares, can be used for robustness check.

And finally, this study is done in the emerging economies context having distinct institutional frameworks. Moreover, several divergences can be observed among the emerging economies in terms of political systems, cultural practices, protection of minority interests, disclosure requirements, enforcement mechanisms, and so on. Cautions required while interpreting the findings of the papers.

### **6.3. Directions for future research**

Further researches are essential in order to advance our knowledge about corporate governance in emerging economies and developing economies and to inform practitioners and policymakers about the antecedents and effects of various government

mechanisms. The contributions made by the papers in this thesis stimulate and motivate researchers to continue research in this field so that some of the research perspectives indicated by the papers may soon benefit from new and consolidated insights.

The first paper analyzed the corporate governance scenario in one of the major emerging economies, India and compared it with the US and UK practices. However, India alone cannot represent all the emerging market economies. Hence, the findings are applicable only in the Indian context. Future research is suggested for the extension of this study by including more emerging economies in one side and developed economies on the other side. The findings from the comparative study among multiple countries will provide the scope of generalization to the broader stakeholders.

Another exciting extension to this study would be a comparative examination of corporate governance and firm performance among different industry groups in India. The firms in different industry groups may have a great deal of variance in firm performance and may require some variances in their governance systems. The cross-industry comparison will help to identify the most benefitted industry sectors from the existing governance systems. There is no ‘one size best fit’ model of corporate governance for all types of listed companies. Some companies, mainly state-owned public companies operating in the less profitable but in highly prioritized sectors of the government to meet social objectives, may require distinct corporate governance approach. It may guide the regulators for further policy amendments.

During the middle of the sample period, a new Companies Act 2013 was introduced in August 2013 and fully effective from 01 April 2014. The Act has incorporated most of the CG rules as hard law, a big regulatory shift of Indian CG from principle-based approach to rule-based approach. Firms are forced to comply with these laws which may bring significant changes the governance of the companies and impact on their performance. It can be an interesting avenue to the researchers to perform a natural experiment for the impact of Companies Act 2013 on CG practices and performance of Indian companies.

In this thesis, two primary internal governance mechanisms, i.e. board characteristics and ownership structures, are examined. The extension of these studies would be done by including other internal mechanisms, such as roles of executive managers and their incentive structures, internal code of conducts, and external governance mechanisms, such as financial and capital markets, markets for managers, and the markets for products and services (Cuervo, 2002). From the extension, the practitioners may build corporate governance bundles to fit for their requirements. Also, they can use governance mechanisms as substitutes (Coles et al., 2001; Weir et al. 2002).

For the empirical papers, a set of control variables and system GMM estimation techniques are used to help to control for potential endogeneity in the study of corporate governance-performance relationship. However, it is impossible to eliminate endogeneity concern, and it remains possible that endogenous relationship among variables is driving the results (Bednar, 2012). Hence, future research needs to identify a better technique for examining the governance-performance relationship to reduce this concern further.

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