"Corporate Governance on Financial Performance: Central Issues and Development in India"

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Abstract – There is ongoing interest in the area of corporate governance. Much of the recent published research into corporate governance and financial performance has focused primarily on U.S. firms and others in developed countries. Less attention has been devoted to firms in emerging markets. This research investigates the relationship between the financial performance and some characteristics of corporate governance for Indian firms.

Keywords: Corporate Governance, Financial Performance, Companies

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INTRODUCTION

Corporate governance is "the system by which companies are directed and controlled". It involves regulatory and market mechanisms, and the roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. In contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees.

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, the board of directors, employees, customers, creditors, suppliers, and the community at large. An important theme of corporate governance is to ensure the accountability of certain individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem.

REVIEW OF LITERATURE:

An unprecedented large number of financial institutions collapsed or were bailed out by governments during the global financial crisis of 2007-2008. The failure of these institutions resulted in a freeze of global credit markets and required government interventions worldwide. While the macroeconomic factors (e.g., loose monetary policies) that are at the roots of the financial crisis affected all firms, some firms were affected much more than others. Recent studies argue that firms' risk management and financing policies had a significant impact on the degree to which firms were impacted by the financial crisis.

The differences in the quality of corporate governance in these developed countries fade in comparison to the chasm that exists between corporate governance standards and practices in these countries as a group and those in the developing world [1]. Corporate governance has been a central issue in developing countries long before the recent spate of corporate scandals in advanced economies made headlines. Indeed corporate governance and economic development are intrinsically linked. Effective corporate governance systems promote the development of strong financial systems – irrespective of whether they are largely bank-based or market-based – which, in turn, have an unmistakably positive effect on economic growth and poverty reduction[2]. There are several channels through which the causality works. Effective corporate governance enhances access to external financing by firms, leading to greater investment, as well as higher growth and employment. The proportion of private credit to GDP in countries in the highest quartile of creditor right enactment and enforcement is more than double that in the countries in the lowest quartile. As for equity financing, the ratio of stock market capitalization to GDP in the countries in the highest quartile of shareholder right enactment and enforcement is about four times as large as that for countries in the lowest quartile. Poor corporate governance also hinders the creation and development of new firms. Good corporate governance also lowers of the cost of capital by reducing risk and creates higher firm valuation once again boosting real investments. There is a variation of a factor of 8 in the “control premium” (transaction price of shares in block transfers signifying control transfer less the ordinary share price) between countries with the highest level of equity rights protection and those with the lowest [3]. Brown and Caylor (2004) [5] determined that board composition was the most important driving factor among the core factors of Corporate Governance Quotient (CGQ). They also found positive correlation between industry-adjusted CGQ scores and financial performance measures - shareholder returns, profitability, and dividend payouts and yields. Van de Velde et al. (2005) [5] analyzed the linkage of corporate governance ratings and financial performance, and found positive but not significant relationship between them. This observation is consistent with the findings of Gompers et al. (2003) [7], who further found that firms with stronger governance structure and shareholder rights enjoy higher firm value, profits and sales growth.

CENTRAL ISSUES IN CORPORATE GOVERNANCE:

The basic power structure of the joint-stock company form of business, in principle, is as follows. The numerous shareholders who contribute to the capital of the company are the actual owners of business. They elect a Board of Directors to monitor the running of the company on their behalf. The Board, in turn, appoints a team of managers who actually handle the day-to-day functioning of the company and report periodically to the Board. Thus mangers are the agents of shareholders and function with the objective of maximizing shareholders’ wealth. Even if this power pattern held in reality, it would still be a challenge for the Board to effectively monitor management. The central issue is the nature of the contract between shareholder representatives and managers telling the latter what to do with the funds contributed by the former. The main challenge comes from the fact that such contracts are necessarily “incomplete”. It is not possible for the Board to fully instruct management on the desired course of action under every possible business situation. The list of possible situations is infinitely long. Consequently, no contract can be written between representatives of shareholders and the management that specifies the right course of action in every situation, so that the management can be held for violation of such a contract in the event it does something else under the circumstances. Because of this “incomplete contracts” situation, some “residual powers” over the funds of the company must be vested with either the financiers or the management. Clearly the former does not have the expertise or the inclination to run the business in the situations unspecified in the contract, so these residual powers must go to management. The efficient limits to these powers constitute much of the subject of corporate governance.

CORPORATE GOVERNANCE HISTORY IN INDIA:

The historical development of Indian corporate laws has been marked by many interesting contrasts. At independence, India inherited one of the world’s poorest economies but one which had a factory sector accounting for a tenth of the national product. The country also inherited four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements, a well-developed equity culture (if only among the urban rich), and a banking system replete with well-developed lending norms and recovery procedures. In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act built on this foundation, as did other laws governing the functioning of joint-stock companies and protection of investors’ rights. Early corporate developments in India were marked by the managing agency system. This contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence, marked by the 1951 Industries (Development and Regulation) Act and the 1956 Industrial Policy Resolution, put in place a regime and a culture of licensing, protection, and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation worsened in subsequent decades and corruption, nepotism, and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and gave firms incentives to develop complicated emolument structures with large “under-the-table” compensation at senior levels.

There have been several major corporate governance initiatives launched in India since the mid-1990s. The first was by the Confederation of Indian Industry (CII), India’s largest industry and business association, which came up with the first voluntary code of corporate governance in 1998. The second was by the SEBI, now enshrined as Clause 49 of the listing agreement. The third was the Naresh Chandra Committee, which submitted its report in 2002. The fourth was again by SEBI — the Narayana Murthy Committee, which also submitted its report in 2002. Based on some of the recommendation of this committee, SEBI revised Clause 49 of the listing agreement in August 2003. Subsequently, SEBI withdrew the revised Clause 49 in December 2003, and currently, the original Clause 49 is in force.

CORPORATE GOVERNANCE: RECENT DEVELOPMENTS IN INDIA:

Liberalization of the Indian economy began in 1991. Since then, we have witnessed wide-ranging changes in both laws and regulations, and a major positive transformation of the corporate sector and the corporate governance landscape. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India in 1992 and its gradual and growing empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 1990's—particularly the Harshad Mehta stock market scam of 1992--followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices, as well as those of companies simply disappearing with investors' money. These concerns about corporate governance stemming from the corporate scandals, coupled with a perceived need of opening up the corporate sector to the forces of competition and globalization, gave rise to several investigations into ways to fix the corporate governance situation in India. One of the first such endeavors was the Confederation of Indian Industry Code for Desirable Corporate Governance, developed by a committee chaired by Rahul Bajaj, a leading industrial magnate. The committee was formed in 1996 and submitted its code in April 1998. Later the SEBI constituted two committees to look into the issue of corporate governance-the first chaired by Kumar Mangalam Birla, another leading industrial magnate, and the second by Narayana Murthy, one of the major architects of the Indian IT outsourcing success story17. The first Committee submitted its report in early 2000, and the second three years later. These two committees have been instrumental in bringing about far reaching changes in corporate governance in India through the formulation of Clause 49 of Listing Agreements

CONCLUSION:

In this paper we found that one of the main challenges facing policy makers is how to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time, ensuring that they do not expropriate excessive rents at the expense of other stakeholders. The empirical evidence to date seems to suggest that this is indeed a problem and that protection of minority shareholders is critical to the development of equity markets.

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