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Impact of Corporate Governance on Firm Performance : An Empirical Analysis of IT and Manufacturing Sectors

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ABSTRACT

Corporate governance is instrumental in the development and functioning of economy and exerts a strong influence on resource allocation. It impacts upon the behaviour and performance of firms, innovative activity, entrepreneurship, and the development of the economy as a whole. This paper aims at studying the impact of adopting Corporate Governance norms as listed by Securities and Exchange Board of India on firm performance. The study has undertaken a comparative analysis across two sectors i.e IT and Manufacturing and attempts to assess the relative importance of the various norms. The findings show that among the various corporate governance norms under the scope of the study, the Disclose of Directors' Remuneration in the Annual Report has a major influence on the performance of organizations across the selected sectors. The disclosure policy gives a certain level of confidence in the minds of the stakeholders and thus facilitated in enhancing the image and the overall performance of an organization.

KEYWORDS: Corporate Governance, Clause 49, Listing Agreement, Disclosure, Compliance Report

INTRODUCTION

Corporate Governance has attracted considerable attention, debate and research worldwide in recent decades. Almost invariably, such efforts gain momentum in the wake of some major financial scam or corporate failure, as these tend to highlight the need for tighter surveillance over corporate behavior. Corporate governance has wide ramifications and extends beyond good corporate performance and financial propriety though these are no doubt essential. In India also, corporate governance has been under scrutiny and is an issue that has gained widespread importance. One key element of improving micro-economic efficiency is corporate governance. In an era of increasing capital mobility and globalization, corporate governance has become an important framework condition affecting the competitiveness. Better corporate governance, therefore, should manifest itself in enhanced corporate performance and can lead to higher economic growth. The positive effect of corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development.

The term corporate governance became a prominent research theme after the publication of Cadbury committee report in the UK in the early 1990s. This is evident from the fact that the number of research papers published in the peer-reviewed scholarly journals in the area of corporate governance has gone up from 641 in 1985-96 to 9717 in 1996-2006 (**Balgobin, 2008**).**Annie and Kaczmarek (2012)** conducted a research recently which points to the importance of a careful selection process of directors by nomination committees. It underlines the role for active leadership on boards, who should be aware of available strategies to ameliorate the negative consequences of board schisms, such as accentuating superordinate board identity and/ or informal meetings. A recent study by **Renders and Gaeremynck (2012)** examines the impact of principal-principal agency problems on the quality and effectiveness of corporate governance structures in listed companies from 14 European countries between 1999 and 2003 and found that the conflict index affects the quality and effectiveness of corporate governance. An empirical analysis across IT and Finance sectors revealed that among the various corporate governance norms under the scope of the study, the Disclose of Directors' Remuneration in the Annual Report had a major influence on the performance of an organization **(Kapooria P, Sharma R C and Kaul D 2012). N Afshan, P Chhetri and S Pradhan (2011)** reviewed various works and addressed the issues in their paper like board characteristics, ownership structure, and impact of pay on firm performance and focuses on the important aspects of pay-performance and concluded patterns of inconsistency among authors with regard to the best board characteristics, ownership pattern and pay level and in determining better firm performance. As per **Pahuja & Bhatia (2010)**,the common theme has been to harness the power of organization for an agreed purpose rather than letting it get diverted to some other purpose. According to **Sahu (2009),** more skeletons tumble out in bear markets than during bull phases and Satyam Computer in India and the collapse of investment banks in the US are cases in point. Reviewing the existing codes of Corporate Governance (CG) in India, **Swain (2009)** analyzed the CG structures and practices and adaptability of CG codes in the Indian context. The paper reveals that India has a good CG mechanism and disclosure practices on par with world counterparts. **Dedman (2002)** summarized the Code of Best Practice published in December 1992 by the **Cadbury Committee**.

OBJECTIVE

An analysis of the adoption of best practices recommended by a governing apex body on the performance of Indian corporates can form a basis for economic reforms in the context of the changing corporate environment. Studying the impact of these best practices on the companies across diverse sectors of the Indian Economy would enable us to analyze the efficacy of the said practices. This study aims at exploring the impact of adoption of recommendations in the Clause 49 of Listing Agreement by SEBI pertaining to corporate governance, by the selected Indian corporate. The present study has taken into account certain practices and investigated their impact on firm performances.

HYPOTHESIS

H_{11}: Firms having established a Remuneration Committee should reflect higher performance than those who do not have such committees (RCOM)

H_{12}: Disclosure of Director remuneration in the Annual Reports has a positive impact on the performance. (DREM)

H_{13}: Certification of Annual Reports by CEO/ CFO has a positive impact on the performance (CERT).

H_{14} : Inclusion of Corporate Governance Compliance Report in the Annual Report will be associated with higher corporate performance (COMP)

METHODOLOGY

A general panel model with dummy variables may be written as :

$$Y_{it}=\alpha_1+\alpha_2 D_{2it}+\alpha_3 D_{3it}+\alpha_4 D_{4it}+\alpha_5 D_{5it}+U_{it} \quad \text{Eq (1)}$$

Where,

i = no of firms 1 to 5

t = no of year 1 and 2

Y_{it} = Performance of ith firm in the ith year (dependent variable) **(PERF)**

α_1 = Intercept

α_2 to α_5= Coefficients of Dummy variables

U_{it} = Stochastic Error

Dummy variables are defined as follows –

D_{2it} = 1 if Remuneration Committee is present & =0,if otherwise **(RCOM)**

D_{3it} = 1 if Directors' Remuneration is included in Annual Report & =0,if otherwise **(DREM)**

D_{4it} = 1 if Annual Reports are certified by CEO/ CFO & =0,if otherwise **(CERT)**

D_{5it} = 1 if Compliance Report is included in the Annual Reports & =0,if otherwise **(COMP)**

Sample Selection

For the purpose of present study, five big companies listed on the NSE, each from IT sector and Manufacturing sectors ,were selected. A Panel study was aimed by obtaining the data of the selected companies from their Annual Reports, over a period of 2 financial years. Overall, there were ten companies and two financial years, providing us with 20 samples for analysis.

Measurement Procedure

The independent variables (X) were captured from the Clause 49 of Listing Agreement of SEBI pertaining to corporate governance norms, namely Formulation of Remuneration Committee, Disclosure of Directors Remuneration, CEO/ CFO Certification, and Compliance Report. As the objective of the study is to establish a linkage between the above-mentioned attributes and corporate performance, we calculated P/E Ratio & Asset Turnover Ratio of the companies over a period of 2 years as a measure of corporate performance. Their average is used as the dependent variable (Y). These 4 independent variables along with the sample set of 20 provides us with a total of 80 observations for the purpose of our panel study.

EMPIRICAL ANALYSIS

On the basis of the selected corporate governance norms, an effort has been made to examine the impact of these factors on the performance of the firm. For this an empirical study has been made and a dummy variable regression model has been used. The main results are as follows:

Dependent Variable : PERF **Case of IT Companies**

	Unstandardized Coefficients		t	Significance Level
	α	Std. Error	α	
(Constant)	$\alpha_1 =$ 7.960	1.493	5.330	.003
RCOM	$\alpha_2 =$ 1.962	1.293	1.517	.190
DREM	$\alpha_3 =$ -6.482	2.477	-2.617	.047
CERT	$\alpha_4 =$ 3.447	2.477	1.392	.223
COMP	$\alpha_5 =$ 4.215	1.829	2.304	.069

The result depicts that the value of α_3 and α_5 are significant at 5% level of significance. This means that D_{3it} (ie Disclosure of Directors' Remuneration in the Annual Reports – **DREM**) and D_{5it} (ie Compliance Report - **COMP**) affect the performance of the IT companies and are key determinant in the shaping the performance of the selected IT organizations.

Dependent Variable:PERF Case of Manufacturing Companies

	Unstandardized Coefficients		t	Significance Level
	α	Std. Error	α	
(Constant)	α_1 =12.500	2.487	5.026	.004
RCOM	α_2 = 1.237	3.316	.373	.724
DREM	α_3 = -7.912	2.308	-3.428	.019
CERT	$\alpha_4 =$ .283	1.658	.171	.871
COMP	α_5 = 2.420	1.436	1.685	.153

The result depicts that the value of only α_3 is significant at 5% level of significance. This means that D_{3it} (ie Disclosure of Directors' Remuneration in the Annual Reports – **DREM**) affects the performance of the Manufacturing companies and is key determinant in the affecting the performance of selected manufacturing organization.

CONCLUSION

It may thus be conclude that Inclusion of Directors' Remuneration in the Annual Report of a company, which is commonly significant in both the sectors, is of vital importance in affecting the performance of the companies across IT and Manufacturing sectors. The remuneration disclosure instills a certain level of confidence in the minds of the shareholders and thus enhances the image and the overall performance of the company. Thus, it may be concluded that among the different recommended norms of corporate governance, disclosure plays a vital role in enhancing a firm's image and hence the performance.

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