

Chapter 1

Introduction

Introduction

1.1 Problem of the Study

Introduction of limited liability in business and subsequent evolution of stock exchanges worldwide not only facilitated the business with funds mobilization but also gave rise to the problem of accountability of managers towards fund providers. Additionally, to exercise the surveillance over management and ensuring the better returns, appointment of 'directors' (collectively called as 'the Board') by the shareowners lead to even more chaotic situation. For this, researchers, business associations and various committees on corporate governance, across the globe, have tried to differentiate between 'board' and 'good board' without differentiating between 'governance', 'non-governance' and 'mis-governance'. Hence, they sought to find the solution in the development of numerous codes envisaging induction of more non-executive directors, possibly independent directors, in the board as well as constitution of audit committee and remuneration committee. Despite all this, the scenario did not change much¹ highlighting superficiality of those codes and trying to scratch the outer surface of the system but not curing the ills of non-governance and mis-governance of the system.

'Board of directors' has been in existence, in incorporated companies, as a legal device to exercise surveillance over management, but recent happenings have compelled people to question the functioning of boards and the role played by them. Though, structure of board of directors, efficient functioning of the management and timely disclosure of information are considered germane to the corporate governance, yet it continues to be plagued by the

¹ There had been ample numbers of latest examples such as collapse of Enron, World.Com, and Xerox in the U.S. where the Securities and Exchange board regulations are supposed to be the toughest in the world. On the other hand the auditing giant Arthur Anderson collapsed because of its misdeeds and helping Enron to cosmetise Enron's financial reports. There are number of cases where the Company alongwith the broker indulged in insider trading, misrepresented their financial statements or remained as willful defaulters of payments of government dues or financial institutions' loan dues.

problems of free rider, managerial hegemony², non-clarity of board's role and position, insider domination, nomination by CEOs, non-availability of competent persons to acquire board's position, lack of time and commitment by outside directors.

In jurisprudence, 'board of directors' is a fiduciary of owners of the company and therefore organization theorists espouse their function as 'directing' and 'controlling' the management. But, in public sector enterprises it's the government that has the power of governance and not the Board. In private sector the problem is that of family fiefdoms where dividing line between ownership and management appears to have blurred leading to class hegemony where family ties and friendship relationships promote the directors' compliance with management because they make the board part of the social network that supports the internal cohesion of the country's corporate families (Kosnik, 1987). Though, the supreme authority of shareholders³, in general meeting, is enshrined in company legislation but the fact remains that the large number of scattered shareholders have no say in any governance matter since their protest to any agenda item is either lost in proxy war or majority vote that are held by the promoters. Agenda items fixed up by the management get resolved without any hiccups. Therefore, the problem of corporate governance is three dimensional, viz., 'who governs', 'how they govern' and 'what they govern'? These aspects are related to governance structure and governance process that are fundamentally based on the human aspects of corporate governance. Human resource aspect stresses upon nomination, appointment, training and succession, performance and appraisal, remuneration, retirement of the directors and corporate values. Usually there is benchmarking on financial aspects of corporate governance which leaves benchmarking for other areas such as human aspect and more vitally strategic aspects.

² Theory of managerial hegemony describes the board as a legal fiction: a co-opted appendage institution that, despite its formal governing power over management, is in fact dominated by corporate management which leads to a passive and compliant "rubber stamp" for management's proposals and decision.

³ They are also referred as "residual risk bearer" since they are subject to the extent of their investment.

1.2 Rationale of the Study

Principal function of the board remains that of providing governance structure and process for the protection of the stockholders which calls for examination of various aspects of this governing body to find out the existence of relationship between various attributes of board, its members and the performance of the organization. Market regulators in India have attempted to introduce structural and procedural changes to improve the governance system by inserting Clause 49 in the Listing Agreement of the Bombay Stock Exchange (BSE)⁴ for the listed companies and also enlarging the scope of law through various amendments to the Companies Act, 1956 and the process of change continues in the form of debate over Companies (Amendment) Bill, 2003. Therefore, the study seeks to examine whether the structural and procedural changes placed by the market regulators in India, have really permeated in the veins of corporate life in terms of operating performance of boards. Researchers in India have studied board structures in terms of size and composition to some extent and not the impact of governance structure and process on the financial and operating performance of the company. The same is the fate of various reports of committees that touch on the structural aspects and leave the grey areas. With a view to fill this void, the present study has been undertaken to study the corporate governance in India so as to analyse the structural, procedural and human resource aspects of corporate governance.

1.3 Review Of Literature

Review of literature on the following aspects of corporate governance has been done.

⁴ Mandatory and non-mandatory requirements under clause 49 mandate introduction of more non-executive independent directors, board committee structure, disclosure norms, information to board members, fixation of agenda items of board meetings etc.

1.3.1 Ownership Structure

Ownership structure⁵ and board composition are affected by law⁶ and political process⁷, however, ownership structure and board composition are strategic complements (Mayers, Shivdasani & Smith, 1977) and when the ownership of the firm changes, it leads to the change in the board structure (Denis & Sarin, 1999). Smith (1990) opined that the greater concentration of stock ownership in the hands of outside board members and other major investors encourage close monitoring of managers' action. Westphal (1998) reported that board ownership was positively related to CEO ingratiation and persuasion to have control over the preferred strategy and compensation outcome. Studies have also shown that changes in ownership and board structure are strongly related to top executive turnover, but are weakly related to changes in firm-specific determinants of ownership and board structure (Denis & Sarin, 1999). But, the board can become redundant when there is a dominant active shareholder, especially when the major shareholder is a family or government (Turnbull, 1997). Furthermore, firms in which higher percentages of shares are held by outside blockholders use less equity-based compensation (Mehran, 1995).

On the other hand Jensen and Meckling (1976) argued that ownership structure, executive compensation structure and board composition are determined by each other and also by the nature of a firm's business. Therefore, in the context of Indian companies, it has been examined whether there exists any relation between the shareholding pattern and the corporate governance structure, shareholding pattern and financial performance of the Company.

⁵ It is defined by the distribution of equity with regards to votes and capital and also by the identity of the equityholders (Jensen & Meckling, 1976).

⁶ e.g. Monopolies and Restrictive Trade Practices Act, 1969 restricted the ownership of corporate families depending upon the assets controlled by the corporate families. Board composition is fixed under the Companies Act, 1956 and also under Listing Agreement of SEBI (Cl. 49).

⁷ Political party in power provides legislative environment in which business is conducted and legislation is enacted with an objective to provide necessary ground to conduct business activities. e.g. Competition Bill was passed in the year 2002 in place of MRTP Act to facilitate Indian companies to grow in size and wealth by corporate restructuring to compete in the liberalized and globalized environment.

1.3.2 Corporate Governance Structure

Governance structure herein includes two aspects, board size and board composition.

Board Size

There is no optimal size of board (Chaganti *et al.*, 1985) and it does not depend on size of capital, net asset, or even sales (Vance, 1983). Although a host of theory-driven rationale suggests a relationship between board size and firm performance, the literature provides no consensus about the direction of that relationship (Dalton, *et al.*, 1999). Contrast to this Chaganti *et al.*, 1985 found that board size has a bearing on corporate failure, and that relatively larger boards have greater chances of survival. An apparent consensus on the issue of relation between the governance structure variables and corporate performance variables is missing. Kesner & Johnson (1990) are of the view that under normal circumstances the board may not be an important direct determinant of firm performance. It was also argued that smaller board is manageable and can perform controlling function whereas larger board is unmanageable and cannot work as an effective mechanism of controlling function but larger boards can provide for the variety of services. Therefore, in Indian context it becomes imperative to enquire whether the board size and financial performance of the company are related.

Board Composition

Board composition has been an area of great concern for academicians and professionals for the want of independency and governance through corporate boards. However, studies have failed to show any relationship between firm performance and board composition (Hermalin & Weisbach, 1991; Mehran, 1995). Nevertheless political process (Shleifer & Vishy, 1997; Chaganti *et al.*, 1985) and the legal environment are important factors for the composition of board of directors. Therefore, in Indian context it is required to analyze various parameters of board composition with respect to demographics and cognitives.

Executive vs. Non-Executive

One of the major concerns of Cadbury report was to promote non-executive directors on the boards for the improvement of accountability of the management and setting of senior executives' pay (Forbes & Watson, 1993). However, the inability of boards to exercise their legitimate governance role arises from board domination by firm managers, i.e., executive directors (ED) or insiders (Fama & Jensen, 1983; Mizuchi, 1983; Vance, 1983). Board is considered as 'independent' when independent directors occupy at least one-half of the board seats. Structural board independence is defined by those aspects of formal position and informal social structure that can potentially reduce the extent to which directors are socially or professionally beholden to the CEO. But an increase in structural board independence from management is regarded as a primary means by which the board's power to protect shareholders can be enhanced (Zahra & Pearce, 1989), however, Westphal (1998) reported that increasing structural board independence can decrease the board's overall power to protect shareholders by prompting CEOs to use interpersonal influence, by ingratiation and persuasion behaviour, as an alternative source of power. Another argument against having non-executive director on the board is that by its design, the non-executive board of directors is an ineffective control device (Donaldson & Davis, 1994) owing to blockade in information made available to board members by executive as also the frequency of absence in meetings rendering them to the status of "absentee directors".

Insider vs. Outsider

Greg & Saporoschenko (2001) defined 'outside directors' as directors not included in any of the following categories – officers or former officers of the Company or its subsidiaries, relatives of officers, directors with known business relationships with the Company, and directors likely to have potential business relationships with the Company, such as

consultants or attorney⁸. Vance (1964) and Pfeffer (1972) reported a positive relationship between outsider orientation and corporate performance whereas Chaganti *et al.* (1985) and Core *et al.* (1999)⁹ could not find existence of any such relationship. Mace (1971) was of the view that outside directors are most powerful and have the greatest opportunity to get involved in governing when the organization is in a performance decline and in an outsider dominated board the performance measures are more highly correlated with CEO turnover which tend to add to firm value through their CEO change (Weisbach, 1988). The central function of outside director is to safeguard the shareholders' investments in the firm in the face of potential managerial opportunism or incompetence (Baysinger and Hoskison, 1990) and therefore the presence of higher percentage of outside members decreases financial statement fraud (Beasley, 1996). The proportion of more outside directors will provide for the external control of the organization which is independent of the management (Chaganti *et al.*, 1985). Incentives to appoint outside directors are many fold as is evident from the studies that the outside directors will act in the interest of shareholders by monitoring top managers (Fama & Jensen, 1983; Brickley & James, 1987; Weisbach, 1988; Mayers *et al.*). Another point of view has been discussed by Rosenstein & Wyatt (1997) that an evidence of a positive stock-market reaction to the appointment of outside directors does not imply that the appointment of an insider is harmful to shareholders and that for a beneficial balanced board, adding an insider manager to an outsider-dominated board will enhance shareholder wealth. Whereas Beasley (1994) explains that 'grey' directors are outside directors who have some non-board affiliation with the firm. Grey directors are potential source of violation of board independence because of their other affiliations with management. Hermalin & Weisbach (1988) found that inside appointments occur with greater frequency when CEOs approach

⁸ Vancil (1997) also stated that outside corporate lawyers who are employed by the firm and also serve on the board are considered insiders since many have conflicts of interest.

⁹ However, their explanation was that since their work was related to a 'retailing' industry only, it can not be generalized and there can be inter-industry differences.

retirement age and that outside appointments are more likely following poor firm performance¹⁰. Outsiders also perform an expert function (Brickley & James, 1987) and attract greater institutional investors' investment, the presence of independent outside directors on the board during takeover attempts enhance shareholder gains by higher initial tender offer premiums and higher bid premiums revisions than do targets without independent boards (Cotter, *et al.*, 1997). Boards dominated by outsiders (i.e. independent directors) are more likely to force resignation of poorly performing CEOs (Weisbach, 1988).

When the board is composed of majority of insiders or outsider grey directors, CEOs have control over the preferred strategy and compensation outcome (Westphal, 1998). In New Zealand the outside representation on the board has been increased by 5% after the enactment of the new Companies Act (Cahan & Wilkinson, 1999). However, they did not study whether increase in outsiders improved board and firm performance. In India also, listing agreement provides for the majority of non-executive/ independent directors, therefore, it is required to study whether Indian companies complied with the law with its letter and spirit to induct outside independent directors and whether non-executive and independent directors were absentee directors. It was also attempted to find the causal relationship between the composition of the board on the basis of type of directors and the financial performance of companies.

1.3.3 CEO Duality

CEO duality occurs when the same person holds both the CEO as well as board chairperson positions in a corporation (Rechner & Dalton, 1991). Organization theorists (Fayol, 1949; Pfeffer, 1981) support CEO duality for the reason that it leads to strong leadership and unity of command while agency theory proponents suggest that duality promotes CEO entrenchment by reducing board-monitoring effectiveness. CEO duality also leads to

¹⁰ Also see Kaplan & Minton, 1994.

concentration and abuse of power in the self-interest at the cost of the shareholders. CEO duality signals the absence of separation of decision management and decision control (Fama & Jensen, 1983) and therefore vigilant boards are unlikely to favour the dual structure. In contrast, Finkelstein & D'Aveni (1994) found that board vigilance was positively associated with CEO duality. CEO duality often controls the process of nominating directors facilitating consideration of individuals who are loyal to the CEO-Chairperson (Berg & Smith, 1978). However, when the CEO represents majority shares then there is no real separation of ownership and control, which minimizes agency costs (Fama & Jensen, 1983). As far as relationship between CEO duality and firm performance is concerned there are contradicting views of researchers. Some studies have reported that CEO duality is unrelated to firm performance (Chaganti *et al.*, 1985; Daily & Dalton, 1992) while Rechner and Dalton (1991) assert that it is negatively associated with firm performance. Lieberman & O'Connor (1972) were of the view that leaders have little impact on organizational performance and that the leaders are constraint by situational factors, however, Thomas (1988) was of the view that individual leadership has little impact on performance at the aggregate level but a substantial one at the level of individual firm. Therefore, it was required to examine that whether CEO duality is in any manner related to firm performance in case of Indian Companies.

1.3.4 Nominee Directors and Their Effectiveness

Although many scholars concluded that actions by institutional investors do not influence management performance in meaningful ways but institutional activism can be effective only for those companies with necessary tools to respond to the challenge to improve performance (Caton *et al.*, 2001). A nominee director draws his support from the appointing authority and also from institutional shareholders who can act as countervailing power against the

controlling group¹¹. Gupta (1989) is of the opinion that the nominee directors should act in the holistic interest of the company while discharging their responsibilities as a nominee of an institution. Hence, it is necessary to see whether in India nominee directors are contributing towards governance of corporates.

1.3.5 Multiple Directorships

Despite many attempts by legislators and market regulators, the problem of determining optimal number of other directorships is an unresolved issue and it has been argued that additional directorships may reduce an individual's monitoring capability as their available time is spread thin (Shivdasani & Yermack, 1999). Core *et al.* (1999) found that the presence of busy directors is positively associated with measures of excess CEO compensation suggesting that such directors are less likely to engage in significant managerial monitoring than other directors who serve on fewer boards. Therefore, it is necessary to enquire whether the multiple directorships and board committee memberships affect the directors' attendance in the board meetings, in board committee meetings and at the AGM.

1.3.6 Nomination of Board Members

CEO influences the nomination process of directors (Shivdasani & Yermack, 1999; Lorsch & MacIver, 1989) either in case of absence of nomination committee or if the CEO serves on the nomination committee. In such nomination process directors are handpicked of the CEO (Mace, 1971) with more grey outsiders having conflicting interest and fewer independent directors (Shivdasani & Yermack, 1999). *De jure* shareholders elect board members as their agents for monitoring the entrenched management's¹² functioning, however, *de facto* position

¹¹ In case of Daewoo Motors India, a move by the Company to increase the number of promoter directors was opposed by ICICI nominee to safeguard the ICICI's interest.

¹² Managerial entrenchment occurs when managers gain so much power that they are able to use the firm to further their own interests rather than the interests of shareholders (Weisbach, 1988).

reveals that it's the management that selects the board members (Hermalin & Weisbach, 1998) and that they are denied nomination for re-election after criticizing management (Tejada, 1997). Therefore, it is required to expound the *de facto* position of nomination process for directors in India.

1.3.7 Board Committees

Despite periodic meetings of whole board, as mandated in the Companies Act, most of management's surveillance is desired to be looked after by board committee members. Board committee members' specialization in a particular field leads to greater efficiency, expediency and flexibility (Kesner, 1988). In India, though, traditionally there used to be share transfer committee (and rarely audit committees), recently the type and number of board committees has increased drastically because of mandatory requirements for their formation, composition and usage. Audit committees were rare until the late 1970s and not universal till 1989 in the U.S. (Pincus *et al.*). New York Stock Exchange mandated formation of audit committee as early as 1973, however, in the last decade efforts were made to have more effective audit committee¹³ since the mere formation remained futile to give the desired results of saving the investors'/ shareholders' interest. Beasley (1996) opined that the presence of audit committee does not significantly affect the likelihood of financial statement fraud and that board' composition, rather than audit committee presence, is more important for reducing the likelihood for financial statement fraud. Similarly, remuneration committee seemed to be associated with higher levels of pay and made no positive impact on the incentive structure of pay (Main & Johnston, 1993) though the foundation of creating remuneration/ compensation committee was laid to curb the excessive pay and unreasonable increments of the executive management (Cadbury Report, 1992). Therefore, it was necessary to look into the genesis of existence of board committees in India, importance of

¹³ By appointing more non-executive directors on the Audit Committee and ascertaining minimum frequency of meetings.

various board committees and issues raised by them on the performance of the management. An attempt was also made to find out the various descriptive statistics about board committees and its' Chairman.

1.3.8 CEO Succession and Training of Board Members

CEOs are responsible and accountable for the actions and reactions of organizational strategy, structure, environment and performance (Dalton & Kesner, 1985). Despite the fact that CEO successions are not rare events, there have been records of market showing negative impact on financial performance of the company in the absence of clear succession planning to the CEO¹⁴. Similarly, the type of successor is equally important. Replacement of CEO from within the organization represents a maintenance strategy and outside successions have been associated with change¹⁵/ turnaround strategies.

When there is a clear demarcation of ownership and management, succession planning becomes quite crucial as a function of board, however, in family run organizations, as in case of most of Asian countries, where the ownership and management intermingles most of the time the successor comes from within the family by default (i.e. an 'insider'). CEO succession is insider when promoted from within the executive spans of their predecessors whereas outside succession occurs when newly appointed CEO was not there in his predecessor's span. However, Dalton & Kesner (1983) reported non-existence of any relationship between inside or outside executive succession and prior performance of firm. Therefore, there is a need to inquire into presence of an institutionalized training of board members for CEO succession planning and the manner in which it takes place in Indian companies.

¹⁴ There have been few examples quoted by Dalton & Kesner (1985) at p. 750.

¹⁵ Mostly in case of poor performance of organization.

1.3.9 Performance Evaluation of the Board

Financial Performance is a central component of monitoring the management (Fama & Jensen, 1983; Johnson, *et al.*, 1993), however, empirical evidence on systematic governance structure and financial performance relationships suggest mixed or inconclusive results. Though, various researchers tried to find out various financial parameters as an effective measures to ascertain the effective corporate governance structure, etc., there is lack of literature on the existence of system of performance evaluation in companies and parameters to measure performance of individual board members. Therefore, an enquiry has been made into the current performance evaluation practices existing for the board and board members in various Indian companies.

1.3.10 Executive and Non-Executive Board Members' Pay

While there is lot of debate on unreasonable pay of directors as compared to other employees in an organization and also in comparison to their work, the low remuneration of non-executive directors has also become an area of concern. Experts suggested to give equity stakes to executive directors (ED) to align the interest of agents and their principals, i.e., shareowners. However, Jensen & Meckling (1976) suggested that even equity stake given to managers would not help much, if the equity stake is small because in that case managers have an incentive to consume perquisites. When directors are handpicked by the CEO (Mace, 1971) or when the CEO influences the nomination process (Shivdasani & Yermack, 1999; Lorsch & MacIver, 1989) even an additional equity based compensation to directors is unlikely to create a significant incentive effect (Gerety *et al.*, 2001). On the other hand because of lack of transparency, it is unclear that the performance related schemes are necessarily in shareholders' interest (Forbes & Watson, 1993). However, reputation effects can provide outside (IND) directors with incentives to monitor managers (Fama, 1980; Fama & Jensen, 1983) since reputation capital is important in the directorship market (Kaplan &

Reishus, 1990; Gilson, 1990). This study seeks to find out various parameters¹⁶ related to the pay of various types of directors.

1.3.11 CEO Pay and Performance

Compensation package of a CEO includes annual salary, bonuses, changes in the values of the CEO's stock, restricted stock, stock options (Murphy, 1993) and commission. Political forces operating both in the public sector and inside organization limit large payoffs for exceptional performance and that the resulting general absence of management incentive in public corporation presents a challenge for social scientists and compensation practitioners (Jensen & Murphy, 1990). Some reasons found by researchers for high CEO payments are: CEOs at firms with greater agency problems receive greater compensation and that board of directors characteristics and ownership structure have a substantive cross-sectional association with the level of CEO compensation (Core *et al.*, 1999). It has been found in the U.S. studies that CEO pay is higher when there exists CEO duality, the board is larger, board members are CEO handpicked, outside directors are grey directors, outside directors are older (more than 69 years) and serve on more than three other boards. CEO pay is lower in case of any one non-CEO internal board member owns atleast 5% of shares i.e. blockholders. Therefore, we tried to analyse whether there is any relation between CEO pay and performance of company, CEO pay and individual financial variables such as promoter/ non-promoter and length of service on the same board.

1.3.12 Corporate Governance vs. Performance of the Company

Proponents of corporate governance are divided on the issue of financial performance as an outcome of good corporate governance. Out of two schools of thoughts, one suggests that good corporate governance does not mean good financial performance and the other suggests

¹⁶ Such as salary, sitting fees, commission and stock options.

that an efficient system of governance and enhanced credibility of a corporate entity will lead to better financial performance. Therefore, later ones have taken financial performance as a criteria to evaluate corporate governance structure, and the former ones have evaluated the corporate governance structure and effectiveness on non-financial parameters¹⁷, viz., it has been stated by Core *et al.* (1999) that weaker governance structures have greater agency problem and that firms with greater agency problems perform worse and Walsh & Seward (1990) opined that increased board independence necessarily improves corporate performance. Mehran (1995) reported that firm's performance¹⁸ is positively related to the percentage of executive compensation that is equity based. Various financial variables have been used by researchers to find out the effective and efficient corporate governance, viz., sales, earnings, and profit margins (Thomas, 1988), profitability and stock price performance to measure the contribution of leadership (Weines & Mahoney, 1981), earnings, productivity and growth (Vance, 1964), stock returns (Weisbach, 1988) and net sales, income, net shareholders' equity income as the measures of performance (Pfeffer, 1972).

1.3.13 Operating Performance (Board Meetings)

Zahra & Pearce were of the view that without sufficient attention to board process variables, little progress can be made in understanding how boards affect corporate performance. We have moved from rubber stamp board to active boards by looking into each aspect of governance, viz., from process driven board meetings to goal driven board meetings (Taylor *et al.*, 1996). The presence and participation of non-executive directors (NEDs) enhance credibility of the board in the eyes of financial institutions and the parent Company (Raghunath, 1997). Law can mandate the disclosure of attendance of directors at meetings

¹⁷ CEO non-duality associated with a decreased incidence of poison pill adoption (Mallette and Fowler, 1992), CEO non-duality and board restructuring with majority of independent directors reduces the opportunity for the CEO and inside directors to exercise behaviour which is self-serving and costly to the firm's owners (Fama & Jensen, 1983; Zahra & Pearce, 1989).

¹⁸ As proxied by Tobin's Q and return on assets

but their participation and deliberations cannot be ensured. Therefore, the present study enquires into the level of operating performance of the board in Indian companies by analyzing the decision-making process at the board meetings, attendance of directors, functioning of board through board meetings, board committee meetings, and audit of corporate governance.

1.3.14 Disclosure on Corporate Governance

Disclosure like other functions of management provides benefit and incurs cost and hence an organization must need the 'information disclosure strategy' (Lev, 1992). Technology induced large organization, requires capital which is gathered from diversified scattered shareholders (owners), shifted the corporate control from owners to managers (Berle & Means, 1932). As per the agency theory (Jensen and Meckling, 1976) agents are assumed to work for the maximization of returns on investments of their principals. However, in the absence of monitoring by large, minority and scattered shareholders (Shleifer & Vishny, 1986) and pessimist institutional investors, the management performs for maximisation of its own utility and distorts the information before disseminating the same to its users. However, the statutory disclosure may lead the management to commit financial statement frauds¹⁹ by showing inflated results that can be curbed down by the increased proportion of outside directors on the board (Beasley, 1996). This study attempted to find out the trend in disclosure on corporate governance and compliance with the mandatory requirements.

¹⁹ "Vikas WSP apparently inflated turnover and profit figures and artificially boosted its profitability over the past few years". It was also alleged that the Vikas WSP failed to come out with any evidence to remove serious doubts cast on the Company's financial statements and that the Company was also not transparent on issues relating to corporate governance" - Investor's Guide, *The Economics Times*, Ahmedabad, August 7th, 2000 and *The Economics Times*, Ahmedabad, August 18th, 2000.

1.3.15 Committee Reports On Corporate Governance

International

High profile financial scams and fraudulent reporting especially in the U.K. became the cause to form the Cadbury Committee and give its' report on financial aspects of corporate governance in December, 1992 followed by amendment in stock exchange listing rules w.e.f. July, 1993 to include recommendations of Cadbury Committee Report. In the U.K. Cadbury Report was followed and supplemented by the Greenbury Committee Report on Directors' Remuneration (July, 1995) and Hampel Committee Report (December, 1997) (which consolidated the Cadbury and Greenbury Committee Reports). In the U.S. Treadway Commission (1987) and Jenkins Report (September, 1994), in South Africa (Mervyn) Kings Committee (November, 1994) drafted code on corporate governance covering workers' participation, affirmative action programmes and a code of ethics (revised version as King's report-II, 2000). In Canada TSE report on 'Where were the directors?' by Peter Dey was published in December, 1994 (followed by 'Five years to the Dey, 1999' which reviewed the status of implementation of the first report's recommendations), AIMA²⁰ Report – Australia in June, 1995, Vienot Report in France and Peters Report in Netherlands were published in July, 1995 and October, 1996 respectively. EASDAQ Rules were published in Europe in September, 1996, California Public Employees Retirement System (CalPERS) statement on 'global corporate governance principles' (1996), Business Round Table (BRT) 'statement on corporate governance' in September, 1997 followed by BRT 'principles of corporate governance' (May, 2002) were the early attempts by various nations to improve corporate governance through various recommendations.

Olivencia Report (1997) in Spain did not propose any legislative changes and stressed upon self-regulation. However, Martini Report (1996) in France recommended greater

²⁰ Australian Investment Management Association.

modernization of French Law. Blue Ribbon Committee on improving the effectiveness of corporate audit committees in 1999, Organization of Economic Cooperation and Development (OECD) principles of corporate governance (1999), CACG principles for corporate governance in Commonwealth in 1999, World Bank Group on corporate governance: A Framework for Implementation in 1999, Preda report on Report and Code of Conduct in Italy (October, 1999), Basel Committee Report (1999), Turnbull Report (focused on internal controls) (September, 2000), Revised version of King Report II (2000), Vienot Committee Report-II in France came in the second round of recommendations on improvements on corporate governance.

There are many industry/ business bodies/ organisations worldwide that recommended various rules and codes for the corporate governance as a precondition of investment by them in companies. Apart from the foregoing committee reports many other countries have their own committee reports for the listed companies whose recommendations are basically on the same lines as that of abovementioned committee reports.

India

Notwithstanding, the Dutt Committee Report (1969) and the Sachar Committee Report (1978) in India the first recommendations on corporate governance were formally published by CII on 'Desirable Code on Good Corporate Governance' in the year 1997 followed by Kumar Mangalam Birla Committee (KBC) (1999) appointed by SEBI and gave its recommendations in the year February, 2000. KBC recommendations were followed by insertion of Cl. 49 in the Listing Agreement of the BSE and Cl. 34 in the Listing Agreement of NSE. Thereafter several committees have been appointed by many other agencies for the development of corporate governance of their respective industries, viz., R.H. Patil Committee (2001) and Ganguly Committee (2002) appointed by RBI for the development of corporate governance in banking industry and UTI code on Corporate Governance (2000).

Very recently in the year 2002 Naresh Chandra Committee and Narayanamurthy Committee²¹ were appointed by Department of Company Affairs and SEBI respectively to review the corporate governance code and suggest changes in the existing laws and codes. Both committees have given their recommendation quite recently and they are still under debate (recommendations of Naresh Chandra Committee Report has been incorporated in the Companies (Amendment) Bill, 2003).

Apart from the aforesaid Committees, there have been some empirical studies undertaken in India, such as, 'Nominee Directors' by L.C. Gupta (1989), 'Boardroom Practices in India' by C.L. Bansal (1989), 'Corporate Management Structure in India' by S.K. Tuteja (1992), and studies on Public Sector Undertakings carried out by Y.R.K. Reddy and Mishra. However, much of empirical studies carried out in India and outside have largely focused on board structure²² including board size, board composition, board leadership structure (i.e. CEOs and CEO Duality), and nominee directors²³, however, the study on corporate governance with an emphasis on the performance of directors, board meeting processes, corporate governance strategy and objectives, directors' training and evaluation has not been touched upon so far. Post KBC report, it was required to see that what changes have taken place to improve the corporate governance in India.

1.4 Objectives of the Study

The study seeks to relate the structural dimensions of corporate governance with operating performance of selected listed companies in India. Specifically, it seeks to –

- (a) Delineate conceptual facets of corporate governance;

²¹ The committee submitted its report in February, 2003.

²² Bansal, C.L. (1989), *boardroom Practices in India*, Aditya Books, Delhi; and Tuteja, S.K. (1992), *Corporate Management Structure in India*, Deep & Deep Publications, New Delhi.

²³ Gupta, L.C. (1989), *Corporate Boards and Nominee Directors*, Oxford University Press, Delhi.

- (b) Enquire into the corporate governance structure in terms of board size and composition and issues related to board committees, shareholding pattern and control, CEO duality, nominee directors and multiple memberships of board members;
- (c) Expound human resource aspect of board members, viz., nomination, appointment, development and succession planning, performance evaluation and remuneration of various types of directors; and
- (d) Expound the corporate governance process by analyzing the conduct of meetings and legal compliances.

Within the scope of above-mentioned objectives, the following hypotheses were framed:

H₁ : Average board size of companies does not change from year to year.

H₂ : There is no significant difference in the average board size of public and private sector companies from year to year.

H₃ : Performance of the company is not related to the board size of the company.

H₄ : Shareholding pattern does not influence the board size of the company.

H₅ : There does not exist any correlation between the board size and financial variables, viz., sales, profit after tax, non-business income, paid-up share capital, reserves and market capitalization .

H₆ : There is no difference between the proportions of ED, NED and IND from year to year.

H₇ : Board composition in terms of proportion of ED, NED and IND does not influence performance of the company.

H₈ : Shareholding pattern does not influence performance of the company.

H₉ : Shareholding pattern of the company does not influence proportion of insiders on the board.

H₁₀: CEO duality does not influence performance of the company significantly.

- H₁₁: Type of chairman, executive/ non-executive, does not influence performance of the company significantly.
- H₁₂: Proportion of executive chairman is significantly higher than the proportion of non-executive chairman in case of performance category – I.
- H₁₃: Presence of stock option plan to directors is not significantly related with the performance of the company.
- H₁₄: There does not exist any relationship between CEO pay and financial variables with respect to sector.
- H₁₅: There is no difference in the average remuneration of promoter CEO and non-promoter CEO
- H₁₆: There is no association between the performance of the company and the status of CEO as a promoter or non-promoter.
- H₁₇: Performance of the company is not influenced by the length of service of the CEO on the same board.
- H₁₈: CEO pay is not influenced by length of service of the CEO on the same board.
- H₁₉: There does not exist any association between the performance of the company and the frequency of meetings held.
- H₂₀: There is no association between the type of directorship and AGM attendance.
- H₂₁: There is no association between the type of directorships and category of board meeting attendance.
- H₂₂: There is no association between the type of directorships and category of board committee meeting attendance.
- H₂₃: Age, number of other directorships, number of board committee memberships across all companies and remuneration received do not influence the attendance record at AGM, board meetings and board committee meetings with respect to type of directorships.

1.5 Research Methodology

This section states about the research methodology of the study explaining the period, sample, data sources, parameters used, tools and techniques employed for data analysis and hypothesis testing.

1.5.1 Period of the Study

The time period of the study spans over 4 years i.e. from April, 1997 to March 31st, 2001. The reason for the choice of this time frame was the publication of CII report on 'Desirable Corporate Governance In India – A Code' (popularly known as Omkar Goswami report) in the year 1997. It was expected that Indian corporates would take initiative on the matter and corporates' annual reports would have disclosures in this behalf. Amidst the non-passage of long awaited Companies (Amendment) Bill, 1997, and non empowerment of Stock & Exchange Board of India (SEBI) to counter the increasing problems of director misdeeds, SEBI deemed it proper to appoint Kumar Mangalam Birla Committee (KBC) in the year 1999 and incorporate the recommendations of the said Committee in the Listing Agreement for revamping corporate governance in India to protect investors' interest by bringing in mandatory and non-mandatory, structural and procedural changes. Following KBC's recommendations, BSE incorporated clause 49 in the listing agreement that required implementation of corporate governance practices in a phased manner. In that, phase I included those companies whose stocks were listed in either group A of BSE or S&P CNX Nifty index as on January 1, 2000, and newly listed companies. Since, in India, companies have various closing dates of financial year, annual reports till 31st December, 2001 were considered for the study.

1.5.2 Sample

The sample of 250 companies for the study was chosen on the basis of market capitalization of companies as on 31st March, 2001. The sample comprised of all 175 companies from 'A'

group²⁴ and 75 companies from 'B1' group having market capitalization Rs.200/- Crores or more. 116 responses could be obtained from 250 companies representing 55.27% of the total market capitalization of companies listed on BSE. Sectorwise it represented 80.17% private sector, 17.24% public sector and 2.59% joint sector companies of the sample. The sample also provided the data of 1229 directors of 116 companies for the FY2000-01 for the study.

1.5.3 Data Sources

Data needed for the study was collected from primary as well as secondary sources. Data has been ferreted out from annual reports of companies, economic dailies and business magazines. Committee reports on corporate governance worldwide including India and empirical studies published in the professional and academic journals were the secondary sources of data. Pre-tested questionnaire was also canvassed, as a primary source of data, to obtain the information concerning various aspects of corporate governance²⁵. Data so collected was further supplemented by interviews with executives/ directors/ company secretaries of companies who have shown their willingness to participate in the study on conceptualization of certain issues. Views expressed by experts, legislators, executives of government and companies, academicians from different parts of the world who participated in National²⁶ and International Seminars²⁷ were also considered while doing qualitative analysis. Questionnaire responses are not crosschecked with the actual practices and they are analysed as they were reported.

1.5.4 Data Analysis

Board composition and governance disclosures have been analysed over the period of study, i.e., FY1997-98 through FY2000-01. Further, the board composition is analysed in the

²⁴ As on 31st March, 2001.

²⁵ Data that has been expressly disclosed in the annual reports or the questionnaire has only been considered.

²⁶ On 'New corporate governance in India' held at Bharatpur, Rajasthan in Nov., 2000.

²⁷ 2 International Seminars organized by Centre for corporate governance and Institute of Directors, New Delhi were held at Mumbai – Jan. 2002 and New Delhi – Sept. 2002.

If the Company performs better than its previous year on any financial variable then it was given mark = 1 otherwise mark = 0. This means if sales figure of the FY1998-99 (i.e. S2) is greater than sales figure of the FY1997-98 (i.e. S1) then mark = 1 and if S2 is less than or equal to S1 (i.e. $S2 \leq S1$) then mark = 0. Therefore, if $S2 > S1$, $S3 > S2$ and $S4 > S3$, then the Company will get maximum mark = 3 for 'Sales' variable and thus maximum 3 marks are possible to obtain under each financial variable. Since there are 4 financial variables, a Company can get total maximum marks = $4 \times 3 = 12$. Needless to mention that theoretical minimum possible mark is equal to 0 (i.e. zero). Thus, possible range of mark is between 0 to 12 that is nothing but the performance index of the Company for the comparison purpose. We carried out this exercise for all 106 companies for whom the data was available on all 4 variables for all 4 successive years. We found that the maximum performance index calculated was 11 and minimum was 2.

The concept behind this methodology was to test the consistent performance of the company and improvement on performance on each variable from year to year to reach to the right conclusion that which companies are relatively performing better in a given sample. The derived performance index scale 2-11 was divided in to 3 categories as follows:

Category - I : Performance index =10, 11 : 42 Companies

Category - II : Performance index =7, 8, 9 : 32 Companies

Category - III : Performance index = 2, 3, 4, 5, 6 : 32 Companies

Derived category I comprises of relatively outperforming companies than companies under category II and category III of the sample. Also, the relative performance of companies under category II is better than category III but less than category I. List of companies' alongwith performance category is given in annexure – I. Performance index and performance category have been used according to the nature of the problem to be studied.

Statistical tools and techniques employed for testing of hypothesis were as under:

To test the null hypothesis numbered H_{10} , H_{11} , H_{13} , H_{16} , H_{19} , H_{20} , H_{21} , H_{22} , chi-square test of independence between two attributes; H_6 and H_{12} , z-test for proportion; H_1 , H_2 , H_{15} - two sample t -test for population means; H_5 - correlation analysis; H_4 , H_8 , H_9 , H_{17} , H_{18} - simple linear regression analysis; H_{14} , H_{23} - multiple linear regression analysis; H_7 - non-linear regression analysis and for H_3 , scatter plot techniques were used. The foregoing inferential techniques have been employed with the help of SPSS software.

1.6 Chapter Scheme

Besides the present introductory chapter, the study spans over seven other chapters. Chapter two delineates various conceptual facets of corporate governance by differentiating it from 'management' and 'administration' and enquiring into the underlying motives of companies on corporate governance objectives, strategy, policies and disclosures. Chapter three narrates 'Corporate governance structure in India' covered by sample companies by emphasizing on the concept of 'independent directors' besides the size and composition of board. Chapter four enquires into board committee structure and their chairmen and raises the important issues related to shareholding pattern and control, CEO duality, nominee directors and multiple memberships. Chapter five expounds HRD aspects of corporate governance, viz., orientation, training and succession planning. Chapter six examines 'performance appraisal and remuneration' of directors with special reference to CEO pay and performance. The corporate governance process is analysed in chapter seven which contains aspects related to board meetings, audit of corporate governance and compliance of legal requirements. The last chapter presents the summary of finding and inferences drawn from the study and offers some suggestions with a view to make the corporate governance robust.