

# Corporate Ethics and capital markets: Study of select Companies listed in Indian Bourses

1. Dr. M D Saibaba, professor, DSATM-Bangalore,
2. Dr. Praveen Kumar Sinha, Associate Professor, DSATM- Bangalore.

## Abstract

Sarbanes Oxley Act, 2002 in US and Cadbury committee's report, 1992 have been two important landmark regulatory rulings regarding the Board structures and independence in the Corporate Governance history. (Byrnes, 2003). In India the latest of the regulations for listing in bourses stems from the adoption of Narayana Murthy Committee's report which has come into force from January, 2006. This report, to a larger extent, primarily, is an adaptation of the above reports. Research evidence in developed and emerging markets indicate that Investors in the capital markets have been valuing companies at a premium which adopt better practices of governance and ethics. (Reena Aggarwal, 2003). Our study of select Indian companies are in consonance with the same.

Key words: *Ethics, Corporate Governance, Tobins' Q*.

## 1. Introduction

**Corporate Governance is beyond the realm of law. It stems from culture and mindset of management. The "substance is inexorably linked to the mindset and ethical standards of the management", N.R. Naryana Murthy, Founder chairman of Infosys Technologies Ltd.**

The board of directors has long been recognized as an important Corporate Governance mechanism for aligning the interests of managers and all stakeholders of a firm. The need to adopt such an approach is to reduce the agency costs and the associated free rider problem. The central role of board of directors in this process has therefore been recognized paramount because the competition to attract foreign capital is high. Post economic reforms, the liberalization wave has catapulted Indian corporate to initiate cross border acquisitions rather than being acquired. Stocks of many Indian firms are actively traded on NASDAQ.

Events like the Asian Financial crisis, Enron, Global Crossing, Parmalat, Worldcom and others have impacted the governance landscape in India also. Recently there has been a similar governance crisis in India (Satyam's Corporate Governance fiasco). Such events suggest the need for policies to promote real board independence and other aspects of board structures to improve Corporate Governance.

Different forms of ownership structures are associated with different sets of agency problems (Oman *et al.* 2003 and Morck and Yeung 2004). In developed countries such as US and the UK where share ownerships are widely diffused, agency problem is more common between managers and shareholders. In contrast, in developing countries characterized with concentrated equity ownership, agency problem is most predominant between controlling shareholders and minority shareholders.

However changes are being observed in board structures perhaps due to a rising trend in India to raise funds through the ADR/GDR route which is compelling Indian corporates and regulators to evolve somewhat hybrid Governance structures when compared to the above variants.

Despite the exuberance due to boom in the capital markets buoyed by economic growth, countries like India can ill afford to maintain structures that perpetuate expropriation of minority shareholders. Foreign investors may be scared of such expropriation and they might well argue for an effective control of the firms themselves, thus, strengthening board independence and other forms of firm-level governance.

Besides addressing agency problems between managers and other stakeholders, Corporate Governance is also important to the economy (Levine, 2004; and Oman *et al.*, 2003). Collier (Collier, 2006) argues that in developing countries with weak legal institutions it is sometimes difficult for foreign investors to seek legal redress when the developing country partner violates the covenants of agreement. Since there are no global law enforcement agencies to deal with the concomitant problems (Collier, 2006), it could be argued that strengthening board independence and other firm-level mechanisms of Corporate Governance could serve as a means of ameliorating the weakness of legal institutions and hence aid the attraction of foreign investment, with significant ramifications to the economy. Sarkar and Sarkar have studied board independence of Indian firms using spline regression methodology and found positive relationship after certain knots. Foreign investors realize that well-governed firms are better able to raise productivity and aid economic growth.

### **Sebi wants cap on boards for independent directors**

The Securities exchange Board of India (Sebi) is considering a proposal to cap the number of company boards that an independent director can sit on. The aim is to ensure that independent directors get enough time to analyse the agenda of the board meetings and make meaningful contributions.(Source Ecomic times :August,2010).The clipping amply demonstrates the need for a meaningful contribution by the independent directors

This paper hopes to extend the understanding of the relationship between board independence and firm values in top Indian companies listed in Indian bourse (Mumbai Stock Exchange-BSE 100)which we will refer to as BSE100.To the best of our knowledge there has been no recent studies in India, post Satyam Fiasco, about board structures. Sarkar and Sarkar have studied board independence earlier –prior to the implementation of Narayana Murthy Committee’s report, 2006.

In order to enable us accomplish this task, the rest of the paper is organized into eight sections. In section two, we present the objectives and hypotheses of the study while section three provides an overview of the

regulatory framework. Section four deals with the theoretical framework and section five deals with survey of literature. The methodology of the study is given in section six followed by a presentation of descriptive and regression results in section seven. Section eight provides the summary and findings of the study.

## 2 Objectives and hypotheses of the Study:

Following are the specific objectives of the study:

1. To investigate whether or not there is a significant relationship between the proportion of outside directors on the board and firm valuations.
2. To investigate whether or not there is a significant relationship between the size of the board and firm valuations.
3. To know the impact of raising funds through the ADR/GDR route.
4. To understand the connection between CEO duality and firm valuations.

### Accordingly we set the following hypotheses:

1. *Board independence does not influence firm valuations.*
2. *CEO duality does not matter in Corporate Governance of Indian companies.*

## 3 Regulatory Environments:

In the United States, the Sarbanes-Oxley Act 2002 has come into being, heralding the start of new far-reaching measures aimed at strengthening Corporate Governance and restoring investor confidence (Jensen and Fuller, 2002). This has been one of the most sweeping reforms in the past 70 years of Corporate Governance history (Byrnes, 2003).

In UK the Cadbury (1992); Greenbury (1995); and Hampel (1998), Higgs and other Committees and the New Combined Code, shaped the Governance requirements with an emphasis on the greater independence of the Board.

In India the latest revisions in the listing regulatory frame work has been with the adoption of Narayana Murthy Committee's report, 2003 by Securities Exchange Board of India (SEBI). The committee, chaired by Narayana Murthy, Chairman of World renowned Software firm, Infosys, has modeled the report on the basis of the above set of regulations. SEBI is the regulator for Indian capital markets for trading in bourses. All companies in India, including the listed companies, operate within the regulatory framework of Indian companies Act, 1956 under the Ministry of Corporate Affairs (MCA).

Indian regulatory frame work is literally the adapted version of Anglo American model .There is a genuine reason for this because recently there is a rising trend in Indian MNC's acquiring companies abroad.(TATA-JAGUAR, ARCELOR-MITAL etc).

SEBI's listing norms for Indian companies has specific provisions regarding the number of independent directors. In case of CEO duality 50% of the board size should compose of independent directors and one third otherwise.

#### **4 Theoretical Frameworks:**

Agency theory provides the theoretical framework for this study. The theory states that in the presence of information asymmetry the agent is likely to pursue interests that may hurt the principal or shareholders (Ross, 1973; Fama, 1980).

In a review of the stakeholder theory, John and Senbet (1998) note that the multiplicity of principals tends to give rise to conflicting interests. The authors note the vitality of board independence and committee structure as means of overcoming the agency problem.

#### **5 Literature Review**

The literature on the relation between board independence (as a Corporate Governance device) and firm performance has registered significant growth, buoyed mainly by studies from developed countries, and to a lesser extent some developing countries. All the post scandal regulations have emphasized the need for greater board independence.

**Concept of Indian MNC:** Despite the usual glitches in functioning of democracy, Indian economy has reasonably good growth track record. The corporate landscape is dotted with more of cross border acquisitions and there is an upward trend in Indian companies acquiring foreign companies. This necessitates a study in the current Indian context board structures.

#### **Board independence**

As suggested by Anderson and Reeb (2004) when outside directors posed questions on the firm's operation during board meetings, inside directors are expected to provide them with satisfactory explanation. Apart from channeling pertinent information to outside directors, inside or outside directors also play a role in monitoring the CEO. While this monitoring role maybe indirect as inside directors themselves are under the evaluation of the CEO, inside directors may channel relevant information to outside directors if there are incidents which prove CEO's entrenchment. In other words if inside directors play an effective monitoring role and alleviate information asymmetries, this may increase the Corporate Governance structure of the firm which will eventually lead to a better firm performance.

Nevertheless, in the actual corporate scene inside directors are usually aligned with the CEO. The CEO who is the highest-ranking executive in the organization has full power in appointing executives who will remain loyal to him/her. Due to their implicit relationship with the CEO, inside directors may not contribute towards effective monitoring of the CEO. Therefore boards with more executive directors do not necessarily lead to enhancing firm performance.

As mentioned in this paper, the importance of outside directors has been recognized even at the level of policy, with codes of Corporate Governance giving a special attention to the need to have a reasonable proportion of them on the board of listed firms. Empirical evidence has shown that properly constituted boards with the right mix of non-executive directors tend to contribute more to performance than boards with a predominance of inside directors ( Weisbach, 1988; Hermalin and Weisbach, 1991; Bhagat and Black 2001; Mehran, 1995;

John and Senbet, 1998; Fosberg, 1989; Yermack, 1996). A closely related issue is the participation of non-executive directors on the main committees of the board.

In an empirical work, Hayes *et al.* (2004) reported no relationship between the fraction of outside directors serving on a committee and the performance of the firm, As a measure of board independence, the ratio of outside directors sitting on the board has been found to be closely related to firm performance (Rosenstein and Wyatt, 1990; Zahra and Stanton, 1988; and Wade *et al.*, 1990). In stark contrast to the above, evidence of a negative relation has also been reported [Agrawal and Knoeber (1996), Weir and Laing (2001) and Daily and Johnson (1997)], while some studies have reported no significant relation [Hermalin and Weisbach (1991) and Bhagat and Black(2000)]. A number of reasons have been advanced for explaining the disparate findings. A key explanation, perhaps, is the difficulty often encountered in the measurement of board independence and the concomitant differences in the measures of such independence.

## 6. Methodology

Selection of 100 companies listed in BSE 100 index of Bombay stock exchange is a fair representation of Indian capital markets.

### Sources of Data

Data for the year 2008-09 regarding the composition of the board, independence, CEO duality has been obtained from the Annual reports of the companies posted on the respective company web sites.

Regarding the financial data related to control variables the data has been collected from the CIME data base (Center for monitoring Indian economy-Prowess).This data base is widely used both by national and international researchers on such allied topics.(Bhagat,Black,Palepu,Sarkar,Mohanty and others)

### Control variables:

- I. *Ln* income: Natural log of income.
- II. Margin: EBIT/Income.
- III.ROE ratio: Market price of the share quoted on the BSE/Book value of the share.
- IV. Ownership: Promoter's holding as provided in the CMIE data base.
- V. Board size: The number of directors sitting on the board of a firm in a particular financial year reported in the 'Corporate Governance' section in the Annual report.
- VI.CEO Dummy: A dummy variable taking a value of 1 if the chairman is non-executive and 0 otherwise
- VII. ADR/GDR: A dummy variable taking a value of 1 if the company has issued ADR or 0 otherwise.

**Method of Analysis:** The method of analysis is by Multiple regressions using SPSS software. First we tested by listing companies whose board size is less than 8 based on Lipton and Lorch's findings. The coefficients were negative. Then we adopted the process of elimination and after a series of iterations we found that the range from 8-18 have positive valuations.

**Section 7 of this paper presents these results.**

**Descriptive Results:**

Multiple regression with ROE as the dependent variable

Table 1

| Descriptive Statistics |           |                |    |
|------------------------|-----------|----------------|----|
|                        | Mean      | Std. Deviation | N  |
| ROE                    | 2.691419  | 2.6731029      | 70 |
| CEODUAL                | .41       | .496           | 70 |
| Promoters holding (%)  | 48.835714 | 21.5414698     | 70 |
| N.LOG IN               | 9.063193  | 1.4562670      | 70 |
| N.log asse             | 9.842823  | 1.3438916      | 70 |
| BRDSIZ                 | 12.14     | 2.397          | 70 |
| BRD INDP               | 6.11      | 1.724          | 70 |
| ADRGDR                 | .54       | .502           | 70 |

**Table 1 provides the descriptive statistics.**

Mean Board size is 12.14 and board independence is 6.11 minimum being 9 and maximum being 18 representing 70 out of 100 companies. Other companies have board size either less than 9 (min 4) or more than 18 (max 20).

Board independence represented by the number of independent directors is 6.11. Fifty four percent of the firms have issued ADR/GDR/FCCD and they have been mainly listed in US, London, Luxemburg and Singapore stock exchanges. Forty one percent firms have board structures with CEO duality

Table 2

| Correlations        |                       |       |         |                       |          |            |        |          |         |
|---------------------|-----------------------|-------|---------|-----------------------|----------|------------|--------|----------|---------|
|                     |                       | ROE   | CEODUAL | Promoters holding (%) | N.LOG IN | N.log asse | BRDSIZ | BRD INDP | ADR GDR |
| Pearson Correlation | ROE                   | 1.000 |         |                       |          |            |        |          |         |
|                     | CEODUAL               | -.023 | 1.000   |                       |          |            |        |          |         |
|                     | Promoters holding (%) | .134  | -.073   | 1.000                 |          |            |        |          |         |
|                     | N.LOG IN              | -.023 | .365    | .068                  | 1.000    |            |        |          |         |
|                     | N.log asse            | -.182 | .314    | .107                  | .652     | 1.000      |        |          |         |
|                     | BRDSIZ                | .194  | .230    | .094                  | .308     | .221       | 1.000  |          |         |
|                     | BRD INDP              | .216  | .079    | .042                  | .154     | .143       | .683   | 1.000    |         |
|                     | ADR GDR               | -.183 | -.218   | -.108                 | -.038    | -.186      | -.077  | .128     | 1.000   |

| Model Summary <sup>b</sup> |                   |          |                   |                            |                   |          |     |     |             |               |
|----------------------------|-------------------|----------|-------------------|----------------------------|-------------------|----------|-----|-----|-------------|---------------|
| Model                      | R                 | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics |          |     |     |             | Durbin-Watson |
|                            |                   |          |                   |                            | R Square Change   | F Change | df1 | df2 | Sig. Change |               |
| 1                          | .444 <sup>a</sup> | .197     | .106              | 2.5268490                  | .197              | 2.174    | 7   | 62  | .049        | 2.294         |

a. Predictors: (Constant), ADRGDR, N.LOG IN, Promoters holding (%), BRD INDP, CEODUAL, N.log asse, BRDSIZ

b. Dependent Variable: ROE

| Model Summary <sup>b</sup> |                   |          |                   |                            |                   |          |     |     |             |               |
|----------------------------|-------------------|----------|-------------------|----------------------------|-------------------|----------|-----|-----|-------------|---------------|
| Model                      | R                 | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics |          |     |     |             | Durbin-Watson |
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a. Predictors: (Constant), ADRGDR, N.LOG IN, Promoters holding (%), BRD INDP, CEODUAL, N.log asse, BRDSIZ

Coefficients<sup>a</sup>

| Model |                       | Unstandardized Coefficients |            | Standardized Coefficients | t            | Sig.        | Correlations |            |         | Collinearity Statistics |           |
|-------|-----------------------|-----------------------------|------------|---------------------------|--------------|-------------|--------------|------------|---------|-------------------------|-----------|
|       |                       | B                           | Std. Error |                           |              |             | Beta         | Zero-order | Partial | Part                    | Tolerance |
| 1     | (Constant)            | 4.767                       | 2.727      |                           | 1.748        | .085        |              |            |         |                         |           |
|       | CEODUAL               | -.237                       | .689       | -.044                     | -.344        | .732        | -.023        | -.044      | -.039   | .791                    | 1.264     |
|       | Promoters holding (%) | .015                        | .014       | .118                      | 1.012        | .316        | .134         | .127       | .115    | .955                    | 1.047     |
|       | N.LOG IN              | .342                        | .294       | .186                      | 1.163        | .249        | -.023        | .146       | .132    | .505                    | 1.981     |
|       | N.log asse            | -.790                       | .309       | -.397                     | -2.556       | .013        | -.182        | -.309      | -.291   | .536                    | 1.865     |
|       | BRDSIZ                | .024                        | .188       | .021                      | .127         | .899        | .194         | .016       | .014    | .456                    | 2.193     |
|       | BRD INDP              | .409                        | .252       | .264                      | <b>1.722</b> | <b>.100</b> | .216         | .202       | .185    | .490                    | 2.042     |
|       | ADRGDR                | -1.486                      | .660       | -.279                     | -2.252       | .028        | -.183        | -.275      | -.256   | .844                    | 1.184     |

a. Dependent Variable: ROE

**Board size:** We find that for 70 companies where the board size ranged from 9-18, the coefficient is 0.194, 't' values being 0.127 and p-value is 0.899. This means it is not significant (refer tables)

**Board independence:** For the same set of companies the coefficient values are positive but significant. Coefficient value is 0.409, 't' value is 1.722, p-value is 0.100 which means it is significant at 10% level.

**CEO Duality:** The coefficient values for CEO duality (for 70 companies--0.023) is negative but not significant.

Adjusted R square is 0.106 and Durbin Watson value is 2.294. F-value is 2.174. This indicates a fair amount of robustness.

## Section 8: Summary and conclusions

Indian regulatory framework specifies the formation of Audit committee with a minimum of independent directors on the committee and the chairman should be an independent member. As indicated the number of independent directors on board is dependent on CEO duality or otherwise. However investors pay premium for adoption of non-mandatory practices. The findings indicate that in BSE 100 (covering about 60-70% market capitalization) companies for board sizes ranging from 9 to 18 have positive valuations. The numbers of companies in this range are 70. This could be due to the mandatory requirements and voluntary formation of committees in line with global practices. It may be noted that board sizes for 100 companies range from 4 to 18. Since the regression values of independent directors is positive and significant points to the fact that reasonably large number of Indian investors do pay premiums for this aspect of independence.

In reality there are instances where some of the independent directors sit on multiple boards thus diluting the position.

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