CORPORATE GOVERNANCE RATING AND ITS IMPACT ON FIRM LEVEL PERFORMANCE AND VALUATION

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PURPOSE
THIS paper examines the firm specific characteristics that drive companies in India to superior governance and sustainability performance and reporting as proxied by their presence in the S&P ESG India index. It further seeks to investigate whether the corporate financial performance is impacted by corporate governance & sustainability performance and reporting.

Design/Methodology/Approach: *This study proposes to use the rating of companies by the S&P ESG India index and company related performance data as available from Prowess (CMIE). The analysis will require the use of Pearson's correlations and regression analysis model to understand whether Indian investors value governance and sustainability reporting.*

Findings: *These findings have important implications not only for the investors, the corporations, and the managers but also for regulatory authorities, governments, and various bodies around the world which are trying to create awareness about better governance and sustainability, particularly in emerging economies like India.*

Research Limitations/Implications: *The sample size of firms taken could have been more to include firms across all sectors. A cross country analysis would have helped us to understand whether similar results emerge in different context.*

Practical Implications: *In Indian context, it would be interesting to understand, how the mandatory Corporate Governance and Business Responsibility reports submitted by companies impact their stakeholder perception.*

Originality/Value: *This study is unique in analyzing whether governance and sustainability rating of Indian corporate translate into stakeholder value creation.*

Key Words: *Corporate Governance & Sustainability, Financial Performance, Sustainability Indices (S & P ESG, India)*

Key Words - *Corporate Governance, Governance Score, Accounting Ratios and Tobin's Q.*

Does good corporate governance (CG) help in creating value? Majority would agree that the link is not well-defined. However, bad corporate governance does destroy value and this has been demonstrated repeatedly by innumerable corporate failures due to bad governance like the Enron scam in 2001, WorldCom problem in 2002, and more recently by the Satyam scandal in India in 2008–2009. It appears that weakness in corporate governance is a risk that neither the investors nor the government/regulators can ignore.

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The definition of CG differs significantly depending on one's view of the world. Irrespective of the definitional approach used, researchers often view corporate governance mechanisms as falling into one of two groups: those internal to firms and those external to firms. From a broad perspective, Zingales (1998) views governance systems as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm. Shleifer and Vishny (1997) define corporate governance as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Taking a broad perspective on the issues, Gillan and Starks (1998) define corporate governance as the system of laws, rules, and factors that control operations of a company.

The simple balance sheet model of the firm, depicted in Figure 1, captures the essence of this relationship. The left-hand side of the diagram comprises the basics of internal governance. Management, acting as shareholders' agents, decides in which assets to invest, and how to finance those investments. The Board of Directors, at the apex of internal control systems, is charged with advising and monitoring management and has the responsibility to hire, fire, and compensate the senior management team (Jensen, 1993). The right-hand side of the diagram introduces elements of external governance arising from firm's need to raise capital.

Further, it highlights that in the publicly traded firm, a separation exists between capital providers and those who manage the capital. This separation creates the demand for CG structures.

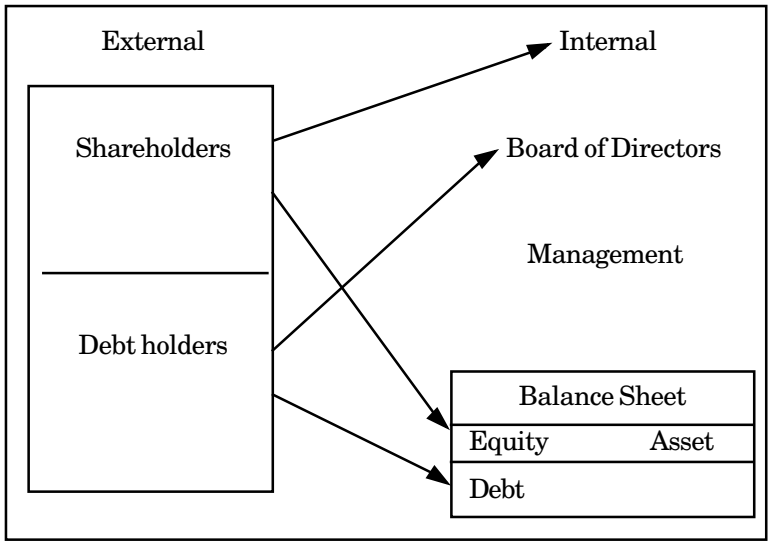

Figure 1: Corporate Governance and the Balance Sheet Model of the firm, Adapted from Power Point slides accompanying Ross et al. (2005).

According to Shleifer and Vishny (1997), the suppliers of finance use CG to ensure that they will get a return on their investment. The diagram also captures the link between shareholders and the board. Shareholders, the residual claimants, elect the board, as per the rules of company law; owe a fiduciary obligation to shareholders. Of course, firms are more than just boards, managers, shareholders, and debt holders. In Figure 2 we provide for a more comprehensive perspective of the firm and it's CG. The figure depicts other participants in the corporate structure, including employees, suppliers, and customers. When added to participants outlined in Figure 1, we have the nexus of contracts view of the firm, as stated by Jensen and Meckling (1976). By incorporating the community in which firms operate, the political environment, laws and regulations, and more generally the markets in which firms are involved; Figure 2 also reflects a stakeholder perspective on the firm (Jensen, 2001)

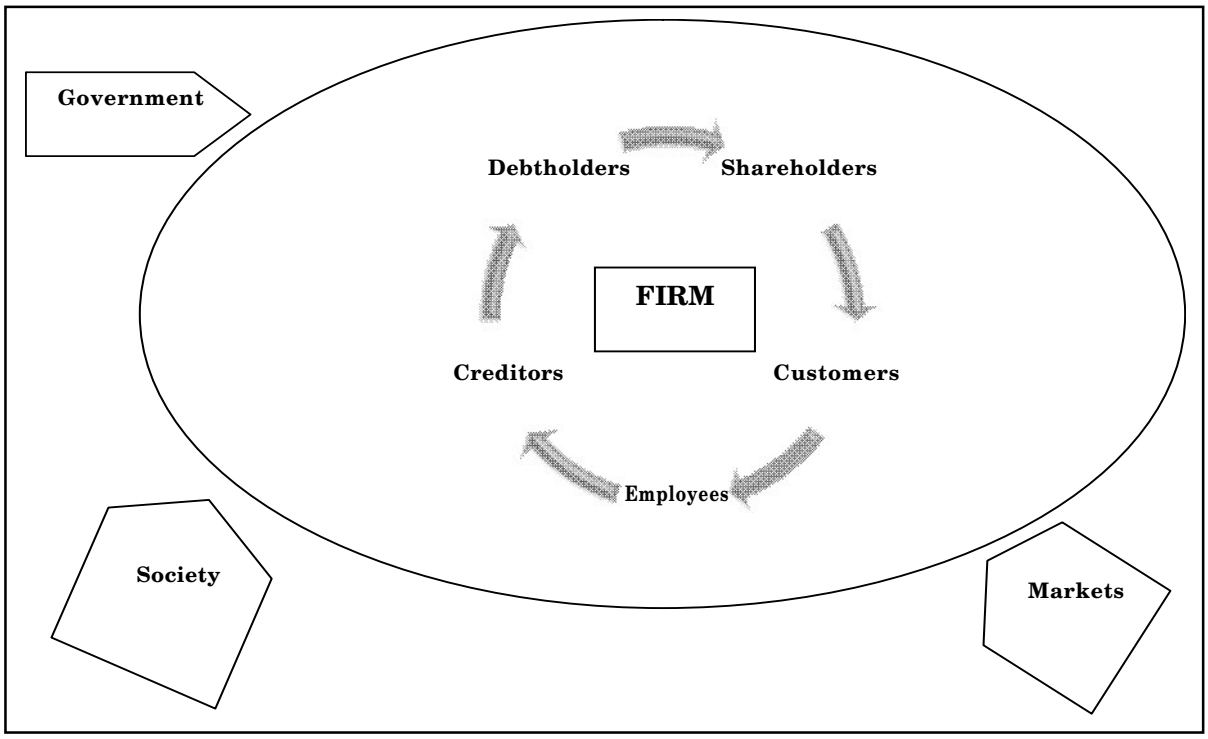

Figure 2: Corporate Governance: Beyond the Balance Sheet Model with all Stakeholders.

In India, CG initiatives began in 1998 with the Desirable Code of Corporate Governance, a voluntary code published by the Confederation of Indian Industry (CII, 1998). In February 2000, the Securities and Exchange Board of India (SEBI) established the first formal regulatory framework for listed companies on CG (Clause 49 of the Listing Agreements) based on the recommendations of the Kumar Mangalam Birla Committee Report, 1999. In October 2004, these were revised following the recommendations of the Narayana Murthy Committee Report, 2003. More recently, in December 2009, the Ministry of Corporate Affairs, Government of India put forward guidelines on CG for voluntary adoption by the corporate sector in India.

As the term CG lends itself to both broad and narrow interpretations, the appropriate management and control structures needed to bring about more transparency in a company's functionality are still unresolved. It is believed that good CG contributes towards a company's overall performance and sustainability, besides enhancing its access to outside capital. It has also been contended that CG serves a number of public policy objectives as it reduces vulnerability to financial crises, reinforces property rights, reduces transaction costs and cost of capital, and leads to capital market development (Javed and Iqbal, 2007).

Does the market then reward firms that practise good CG? This is the question we propose to answer in this paper. The objective is to test the hypothesis that firms with better CG practices receive better market valuations.

The recently enacted Companies Act, 2013 is a landmark piece of legislation and is probably going to have far reaching consequences on all companies incorporated in India. The erstwhile Companies Act, 1956 was ineffective at handling present day challenges of a growing industry and the complexities related with the growing stakeholders' interests. The new Act will substantively raise the bar on governance and in a comprehensive form purports to deal with relevant modern age themes. There are

six main thrust areas and these are (i) Increased Reporting Framework (ii) Higher Auditor Accountability (iii) Easier Restructuring (iv) Greater Emphasis on Investor Protection (v) Wider Director and Management Responsibility and (vi) Inclusive CSR Agenda. On the flip side, it appears to be pervasive and thrusts greater responsibility and obligation on the Board of Directors and Management. Market regulator SEBI also has approved a variety of proposals to amend the Listing Agreement. One of these proposals is the compulsory creation of a whistleblower mechanism.

Review of Literature

A number of studies have examined the relationship between CG and firm performance (Becht et al., 2003; Denis and McConnell, 2003; Gugler et al., 2004; Hermalin and Weisbach, 1991; John and Senbet, 1998; Shleifer and Vishny, 1997, among others). Mitton (2001) in a cross-country study of the Asia-Pacific region found that firm-level differences in CG had significantly influenced firm performance during the East Asian crisis. This study also showed that higher price performance is related to higher disclosure quality, higher outside ownership concentration, and to firms that are focused and not diversified. In a similar study conducted by Brown and Caylor (2006), they looked at 2327 firms in the U.S. and found that better governed firms are also more profitable, more valuable, and pay higher dividends. Similarly Gompers et al. (2003) found that firms that have strong shareholders' rights have higher firm value, higher profits, and higher sales growth.

The number of independent directors is also often cited as proxy for good CG. Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) found that the market rewards firms for the appointment of independent directors. In a similar manner Anderson et al., (2004) found that bond yield spread, used as proxy for cost of debt, are inversely related to board independence. On the other hand, Fosberg (1989) found no relation between the proportion of independent directors and various firm-level performance measures. Hermalin and Weisbach (1991) and Bhagat and Black (2002) also found no link between the proportion of independent directors and value of the firm as measured by Tobin's Q. Thus, the evidence relating to board independence and firm value varies. The evidence pertaining to audit-related governance factors and firm performance is also mixed. However, Yermack (1996) and Brown and Caylor (2004) found that the separation of the CEO's and the Chairman's positions in a company makes the firm more valuable.

In existing literature mixed findings on the direction of causality between firm performance and CG have been reported (Chidambaran et al., 2007; Core et al., 2006; Lehn et al., 2005) and the relationship between CG and financial performance has been largely inconclusive (Larcker et al., 2007). However, such studies have been done mostly for developed countries such as the US, Japan, and Germany (Shleifer and Vishny, 1997). Research on CG is in its infancy in India due to the relatively opaque disclosure practices followed by Indian companies (Goswami, 2003). Further, CG development is not that rapid in Asian countries such as India (Lyngaas, 2003).

A prominent feature in the Indian context is that Financial Institutions prefer to invest in large companies. As a result, their role in governance related matters is not clear. Imperfect product market, illiquid capital market, rigid labour market and regulatory environment, and lack of adequate contract enforcing mechanisms in turn leads to additional governance challenges (Khanna and Palepu, 1997). This leads to information asymmetry between stakeholders and company. Stakeholders prefer to deal with companies that offer better disclosure of information and are willing to pay a premium to buy the services of such companies which contributes to the bottom line of the firms in the long run. Companies with good governance practices raise money at a lower cost of debt.

Data and Methodology

To examine the relationship between corporate governance and firm level performance, we used the CG score obtained from the Standard & Poor's (S&P) Enterprise Governance Score (ESG) India Index as proxy for firm level governance quality, and select financial indicators/ratios and Tobin's Q as measures of firm-level performance.

The S&P ESG India index was introduced in January, 2008. It provides investors with exposure to a liquid and tradable index of 50 of the best performing stocks in the Indian market as measured by environmental, social, and governance parameters. This index represents the first of its kind to measure environmental, social, and corporate governance (ESG) practices based on quantitative as opposed to subjective factors. The index employs a methodology that quantifies a company's ESG practices and translates them into a scoring system which is then used to rank each company against their peers in the Indian market. Its quantitative scoring system offers investors complete transparency.

For data analysis, two approaches were adopted. In the first approach, the firms were categorised on the basis of their S&P ESG ranking as on June 29, 2012 and their financial indicators/ratios were compared. The indicators/ratios for the last 5 years, till March 31, 2012, as available from Prowess (CMIE) were compared:

i. Sales/Income

ii. Profit after tax (PAT)

iii. Return on capital employed (ROCE)

iv. Return on net worth (RONW)

v. Debt equity ratio (D/E ratio)

In the second approach, regression technique was used to empirically test the nature of the relationship between governance score and market value as measured by Tobin's Q. In Tobin's Q measure, the market value of equity reflects the discounted present value of a company's expected future income stream. Therefore, Tobin's Q ratio takes into account the future prospects of the firm, and provides a measure of the management's ability to generate future income stream from an asset base (Short and Keasey, 1999). Since, stock prices move in accordance with changes in market expectations about future cash flows and the cost of capital, this is a forward-looking measure of a firm's performance. Thus, a higher Tobin's Q indicates higher valuation by the market. Tobin's Q was measured using the following formula:

Tobin's Q = [(Total Assets + Market Capitalisation – Net worth) / Total Assets]

Despite several weaknesses in both financial and market-based measures, an increasing number of studies now rely on market-based measures. Demsetz and Lehn (1985) used accounting measures, but Demsetz and Villalonga (2001) shifted to market-based measures as they found it to be more appropriate. Therefore, higher reliance on market-based measures is justifiable for two reasons: First, market-based measures are possibly less prone to accounting variations as the firm has lesser control over it and secondly, they tend to reflect investor perceptions about the firm's future prospects.

Thus the Empirical specification is:

$$GOVSCR = \alpha_{0+} \alpha_1 TOBIN'S\ Q + \alpha_2 SALES + \alpha_3 RONW + \alpha_4 ROCE + \alpha_5 DEBQRAT + \alpha_6 PAT + error,$$

Where, GOVSCR= Governance Score, α_0 = Constant term, RONW= Return on net worth,

ROCE= Return on capital employed, DEBQRAT= Debt/equity ratio, PAT= Profit after tax, and Epsilon (ϵ) = Error or random term.

Empirical Analysis and Results

The comparative analysis of the financial ratios is given in Table 1. This table has been prepared using five years data for the period from March 31, 2008 to March 31, 2012. The mean of the various attributes have been considered and the highest and the lowest have been identified.

Table 1: Comparative Analysis of the Various Attributes for a Period of 5 Years

ESG Rank	Companies	Income (Mean) (Rs. Millions)	Income (Coefficient of Variation)	PAT (Mean) (Rs. Millions)	RONW (Mean) %	ROCE (Mean) %	D/E Ratio (Mean) %	Tobin's Q (Mean
1	Reliance Infra	110,026.51	0.38901586	11,321.12	**8.006667**	5.616667	0.438333333	1.13
2	ITC	252,408.40	**0.228008435**	**45,999.62**	**30.95667**	**30.65833**	**0.008333333**	3.40
3	Lanco	51,314.41	**0.506796761**	**2,454.50**	10.57833	6.48	0.895	1.24
4	L&T	369,522.47	0.28899327	35,644.08	22.26667	15.98333	0.398333333	**1.15**
5	BPCL	**1453679.72**	0.287007228	11,772.52	9.22	3.761667	1.528333333	**5.76**
6	Reliance Cap	**23,222.67**	0.246853128	5,462.55	8.258333	**3.316667**	1.93	2.38
7	IDFC	37,993.84	0.372265638	11,350.50	14.48333	17.64	**3.87**	1.53
8	HCL Tech	57,660.33	0.334195004	13,189.85	27.12	23.73833	0.158333333	2.32
9	M&M	207,762.11	0.41860418	19,634.45	24.495	17.50167	0.425	1.40
10	Indusind	36,176.43	0.460075846	4549.683	15.47667	5.488333	1.886666667	1.19

** Note: Highest and Lowest values have been highlighted for each of the attributes.*

Source: Primary Data.

The researcher measured firm size by sales revenue or Income (Baumol, 1959). The Coefficient of Variation indicates volatility. It indicates that the higher the variance, the less stable is the company's profit. The next indicator is the average profit. Besides these indicators, we calculated two more proxies of profit margins, RONW (PAT/Average Net worth) and ROCE (PAT/ Average capital employed). The next measure is Debt/Equity Ratio. It is a measure of the indebtedness of the firm over its equity or base capital. Although there is no conclusive evidence to suggest that less leveraged firms are superior to more leveraged firms, our results too show that ESG ranking has no relation to this ratio.

We then calculated the correlation among the various attributes. The correlation results between the various attributes have been highlighted in Table 2. From the Table 2 it was observed that Return on net worth (RONW) seemed to be positively correlated with Return on capital employed (ROCE) with (0.923, p=0.000), Profit after tax (PAT) with (0.745, p=0.013) and Tobin's Q with (0.859, p=0.001). This signified that companies with a high RONW is likely to have a high ROCE, PAT, and Tobin's Q score. Similarly it was observed that Return on capital employed (ROCE) was positively correlated with Return on net worth (RONW) as discussed earlier, PAT with (0.749, p=0.13) and Tobin's Q with (0.875, p=0.001). This signified that companies with a high ROCE is likely to have a high RONW, PAT, and Tobin's Q score. PAT was observed to be positively correlated with RONW, ROCE, and Tobin's Q score with (0.807, P=0.005). This signified that companies with a high PAT are likely to have a high RONW, ROCE, and Tobin's Q score. Tobin's Q score was observed to be positively correlated with RONW, ROCE, and PAT as discussed earlier.

We have used regression technique to empirically test the nature of the relationship between governance score and market value as measured by Tobin's Q. This regression analysis was conducted to empirically test the nature of the relationship between governance score, market value, as measured by Tobin's Q, and various accounting measures. Accounting measures includes Sales, RONW, ROCE, Debt/Equity Ratio, and PAT. Table 3 highlights the model specification.

We observe that only Sales and RONW have a significant impact on governance score. Therefore, 90

Table 2: Correlation Matrix of the Attributes for Five Years

Correlations								
		Company	Sales	RONW	ROCE	Debt Eq.	PAT	Tobin's Q
Company	Pearson Correlation	1.000	-0.478	-0.251	-0.268	-0.267	-0.43	-0.129
	Sig. (2-tailed)	–	0.163	0.484	0.454	0.457	0.905	0.723
	N	10	10	10	10	10	10	10
Sales	Pearson Correlation	-0.478	1.000	-0.168	-0.211	-0.038	0.124	-0.105
	Sig. (2-tailed)	0.163	–	0.642	0.559	0.917	0.732	0.772
	N	10	10	10	10	10	10	10
RONW	Pearson Correlation	-0.251	-0.168	1.000	0.923**	-0.498	0.745*	0.859*
	Sig. (2-tailed)	0.484	642	–	0.000	0.143	0.13	0.001
	N	10	10	10	10	10	10	10
ROCE	Pearson Correlation	-0.268	-0.211	0.923**	1.000	-0.330	0.749*	0.875**
	Sig. (2-tailed)	0.454	0.559	0.000	–	0.352	0.013	0.001
	N	10	10	10	10	10	10	10
Debt Eq.	Pearson Correlation	-0.267	-0.038	-0.498	-0.330	1.000	-0.485	-0.575
	Sig. (2-tailed)	0.457	0.917	0.143	0.352	–	0.156	0.82
	N	10	10	10	10	10	10	10
PAT	Pearson Correlation	-0.043	0.124	0.745*	0.749	-0.485	1.000	0.807**
	Sig. (2-tailed)	0.905	0.732	0.013	0.013	0.156	–	0.005
	N	10	10	10	10	10	10	10
Tobin's Q	Pearson Correlation	-0.129	-0.105	0.859**	0.875**	-0.575	0.807**	1.000
	Sig. (2-tailed)	0.723	0.772	0.001	0.001	0.082	0.005	–
	N	10	10	10	10	10	10	10

*** Correlation is significant at the 0.01 level (2-tailed).*

** Correlation is significant at the 0.05 level (2-tailed).*

Source: Primary Data.

Table 3: Model Specification

Attributes	**Model Specifications**
Tobin's Q	-0.071, (0.747)
Sales	0.608, (0.062) *
RONW	-2.195, (0.083) *
ROCE	1.787, (0.172)
Debt/Equity	1.370, (0.264)
PAT	1.810, (0.168)
R^2	0.900
Constant	0.000

** Significant at 10% level.*

Source: Primary Data.

percent of the variation in sales and RONW can explain the variation of this model and 10 percent remains unexplained.

Conclusions

Although CG has gained substantial ground in India, it has begun to make an impact only relatively recently. CG formally became a part of the regulatory framework for Indian listed companies with the introduction of Clause 49 of the Listing Agreements in February 2000. However, very limited evidence exists as to how ESG practices have impacted firm-level performance or valuations within the Indian context.

Better governed firms not only command a higher market valuation but are also less leveraged. Further they provide a higher return on net worth and capital employed, and additionally their profit margins are relatively more stable. They suggest that investors are actually using the information available from companies on their governance practices and returns to differentiate between companies. This would imply that companies had an interest in improving their corporate governance practices as well as in publicising the measures that they take since this would contribute to an improvement in their market valuations.

Note

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