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Impact of Corporate Governance Disclosures on Firm Performance

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ABSTRACT

Corporate Governance disclosure practices are the subject of academic, professional and regulator debate. In this study, we examine the impact of corporate governance disclosures on firm performance in India. Unlike most of the existing literature, the corporate governance disclosures score is computed based on the Clause 49 of the listing agreements of SEBI for the period 2006-2016. It is a handpicked data from the annual reports disclosures made under the corporate governance section. We apply fixed effect regression model to examine the impact of corporate governance disclosures on firm performance. The performance is measured in in terms of operating, financial and market performance. It is found that corporate governance disclosures have positive and significant impact on market performance of the firms. Thus, the companies that comply with regulatory requirements of corporate governance disclosures achieve higher market performance. The study also finds that corporate governance disclosures have positive impact on firm's operating performance and a negative impact on firm's financial performance. The findings are useful to policy makers, managers, analysts and investors and also provide scope for future research.

Key words: market performance, corporate governance disclosures; firm performance; Clause 49; SEBI; India

1. Introduction

Corporate Governance refers to the set of principles or guidelines on which the firm is governed. They have to be clearly articulated and adequately disclosed. Thus, corporate governance and disclosure practices are the subject of concern for researchers and regulators around the globe. Even though the concept of corporate governance has emerged well before, the real theoretical discussions have begun during 1990s. Economic crisis and corporate failures have initiated the discussion on corporate governance in both industry and academia. In Asia, corporate governance practices have come under increased scrutiny during 1997 due to the Asian Economic Crisis. Lack of good corporate governance is one of the reasons for crisis in Asia and other places such as South America and Russia. There are two important strands of literature which discuss the corporate governance issue. One, earlier branch of literature discusses the corporate governance guidelines and legal systems which examine the prominence of the legal systems and corporate governance mechanism (Shleifer and Vishny, 1997; La Porta *et* al, 2000). It is observed that a properly enforced law provides a better corporate governance culture including the protection to small as well as minority shareholders. The other strand of literature discusses the corporate governance guidelines and its impact on firm performance (Garay *et* al., 2008; Vieira *et* al., 2011, Chahal and Kumari, 2013; Aggarwal, *et.* al. 2016; Rose 2016; Arora and Sharma 2016).

Various measures of corporate governance are used to examine the relationship between corporate governance and firm performance. One, the corporate governances is measured based on board variables such as board size, promoter's ownership, board busyness and CEO duality. Second, corporate governance indices are computed based on corporate disclosure practices and select variables. (Judge *et* al., 2003; Black *et.* al., 2006; Vieira *et* al., 2011; Zabri *et* al., 2016). Judge *et* al (2003) found that the corporate governance guidelines are essential for a better firm performance. They also observe a negative relationship between CEO duality and firm performance because the Russian law prohibits CEO to serve as the board chair. In case of Korea, Black (2006) has shown that the corporate governance index is an important factor for explaining share price of the listed firms and observes a positive relationship between corporate governance index and higher share price. Vieira *et* al (2011) have shown that there is a positive association between corporate governance and firm performance in Brazil. Zabri *et* al (2016) showed that the two corporate governance indicators such as board size and board independence have a weak relationship with firm performance in case of the Malaysian listed firms.

Over the period, due to increase in various corporate frauds, corporate governance practices of companies across the globe became focus of attention. Capital market regulators made corporate governance as a mandatory part of compliance requirement and included in financial disclosures and reporting practices. However, limited literature is focused on the corporate governance from a compliance requirement perspectives and its impact on firm performance. Thus, the present study contributes to this limited literature by examining the impact of corporate governance disclosure practices on firm performance. Unlike most of the existing studies, the corporate governance score is computed based on Clause 49 of listing agreements of Securities Exchange Board of India (SEBI). It is a hand-picked data collected from the annual reports of the companies. The study has employed fixed effect regression model to analyse the impact of corporate governance disclosures on the performance variables such as Tobin's Q, return on equity (ROE) and return on assets

(ROA) for a period of 11 years ranging from 2006-2016. The study finds that the corporate governance disclosures have a positive impact on the firm's market and operational performance. It implies that companies that comply with regulatory requirements achieve higher market performance.

2. Corporate Governance Guidelines in India

The single most important development in the field of corporate governance and investor protection in India has been the establishment of the SEBI in 1992. The need for capital, led to corporate governance reform for which the Confederation of Indian Industry (CII), pressed the government to make the central elements of the code mandatory for public firms, which SEBI did the following year, by adopting a reform package known as Clause 49. The Firms that do not comply with Clause 49 can be delisted and face financial penalties. For the purpose of the study many authors construct corporate governance index and allotted score for each variable, in this study clause 49 is used as a corporate governance index. Appendix I shows clause 49 of the listing agreement issued by SEBI.

The remainder of the paper is presented as follows. The third section presents the review of literature and hypothesis development. The fourth section deals with data collection, variables description and econometric model. Subsequently fifth section presents results, analysis and discussions. Finally, the last section provides the conclusions of the study.

3. Review of Literature

Corporate governance (CG) philosophy is used to direct and control the companies. The twin objective of any corporate governance mechanism is to ensure transparency in the operations of the business and accountability to their stakeholders. Large number of literature (such as Hermalin and Weisbach, 1991; Barnhart *et* al, 1994; Yermack, 1996; Bhagat and Black, 2002; Gompers, *et* al, 2003; Durnev and Kim, 2005; Black *et* al, 2009) have studied the association between corporate governance and firms' performance. Some of the studies found a strong correlation between corporate governance and firm performance. Durnev and Kim (2005) shows that better the corporate governance certainly increases the market value of the firms and the firms with greater growth opportunities follow a better governance practices across twenty seven countries in the world. Gorden *et* al (2012) have found that the financial performance is positively related to corporate governance compliance among the small listed firms in Canada. Rose (2016) demonstrates that there is positive relationship between corporate governance score and firm performance among Danish firms. It also observes that measuring the degree of compliance cannot be done in a mechanical way instead it must be customized to the respective country's institutional environment. Akbar et al (2016) showed that the compliance of corporate governance regulations is not a determinant of firm performance in UK. It is found that the compulsory implementation of corporate governance for the UK listed firms have resulted less shareholders friendly environment. The study also suggests that governance mandates can be tighten, but not eliminate, the value gap between poorly and well governed firms.

As far as the emerging markets are concerned, Black (2001) has examined a small sample of 21 firms in Russia with limited control variables, and reports a strong correlation (with r = 0.90) between Corporate Governance and firm performance. It was identified that a change in the market value can be predicted by a worst to best governance change. Klapper and Love (2004) examine the firm-level corporate governance rankings and find that higher Tobin's Q is a result of better governance and disclosure standards. They find that the good governance has more relevance in those countries where they have weaker legal system.

In Indian context, Mishra and Mohanty (2014) examine the relationship between corporate governance and firm performance and find that legal compliance indicator does not influence the firm performance. Abraham et al (2015) has examined the corporate disclosure practices among Indian companies during the pre and post mandate period. They find that the governance compliance practice have improved after the compulsory implementation of corporate governance mandate. They also find that private sector companies observe better compliance practices than the public sector companies. Arora and Sharma (2016) examine the impact of corporate governance on firm performance for large representative sample from India and find that return on equity and profitability is not related to corporate governance indicators. Mishra and Kapil (2017) have found that the corporate governance variables are more reactive towards Tobin's Q than ROA. It is found that promoter ownership, institutional ownership; FIIs presence has a positive relationship with firm performance. The board independence does not have any significant influence on firm performance.

Thus, the existing literature on impact of corporate governance and firm performance show the mixed results. Judge *et* al (2003), Klapper and Love (2004) and Black (2006) have argued that a better corporate governance mechanism have shown a positive association with firm performance. However, Zabri *et* al (2016) has argued that better corporate governance practice do not necessarily result into better firm performance. In case of India, Abraham et al (2015) has shown that the corporate disclosure practices are improved after the compulsory implementation of corporate governance mandate in India. Arora and Sharma (2016) have found that during the initial period of corporate governance compliance requirement, the relationship among corporate governance and performance is not strong. Subsequently, with the mandate of corporate governance disclosures, they found significant positive relationship between corporate governance and firm performance. However, very few studies have attempted to connect compliance requirement of corporate governance and firm performance. The present study fills the research gap by examining whether such alternative measure of corporate governance that is corporate governance disclosure practices has any impact on firm performance. The firm performance is measured in three alternatives ways that is market, operating and financial performance based on Tobin's Q, return on assets and return on equity respectively. In this regard, the following three hypotheses are proposed for empirical testing.

i. *Examine whether corporate governance has positive impact on market performance of the firm (H1).*
ii. *Examine whether corporate governance has positive impact on firm's operating performance (H2)*
iii. *Examine whether corporate governance has positive impact on financial performance of the firm (H3).*

4. Research Methodology

In this study, we examine the impact of corporate governance practices on firm performance of S&P CNX Nifty 50 (also known as Nifty 50 or blue chip) companies. The corporate governance scores of these companies are computed based on the corporate governance disclosures published in the annual reports of companies for the years i.e. 2006-2016. These corporate governance disclosures are mandatory in nature and are in in line with the Clause 49 of the listing agreements of, capital market regulator, SEBI.

4.1 Data

The financial data is collected from Prowess database, one of the prominent Indian economy data base managed by Centre for monitoring of Indian Economy (CMIE). The study has used longitudinal data which have both time and space dimensions. The balanced panel data series consists of forty cross sections and 440 yearly observations from 2006 to 2016. The data set is used to construct the variables such as leverage, size, yield, age, Tobin's Q, Return on Assets and Return on Equity. The corporate governance score is a hand-picked data obtained from the annual reports of respective companies over the period of time. During the initial analysis, the study has included the fifty companies drawn from the NSE Nifty 50 index. Later, six financial sector companies are excluded due to its peculiar features. Further, four companies are excluded due to insufficient data points.

4.2 Econometric Model

In order to address the issue of corporate governance disclosures and firm performance, the study has to analyse longitudinal data, which has both time series and cross sectional components. To overcome the limitations of ordinary least square and panel regression, the fixed effect model (FEM) and Random Effect model are taken into consideration for examining the problem. The Hausman test (1978) is conducted to choose between random or fixed effect models. The test suggests that the fixed effect model is more appropriate. The main advantages of fixed effect model is that it uses within group variations overtime and never consider the across group variation since it may reflect the omitted variable bias. Further, the study has to account for various control variables that may affect the left hand side of the equations. The pertinent control variables are considered based on the extant literature. Thus, the following econometric models are proposed for empirical testing.

$$\text{Tobin's } Q_{i,t} = \alpha + \beta_1 CGscore_{i,t} + \beta x \text{ controls}_{i,t} + \mu_i + \varepsilon_{it} \quad . \ . \ . \ . \ . \ (1)$$

$$ROA_{i,t} = \alpha + \beta_1 CGscore_{i,t} + \beta x \text{ controls}_{i,t} + \mu_i + \varepsilon_{it} \quad . \ . \ . \ . \ . \ . \ (2)$$

$$ROE_{i,t} = \alpha + \beta_1 CGscore_{i,t} + \beta x \text{ controls}_{i,t} + \mu_i + \varepsilon_{it} \quad . \ . \ . \ . \ . \ (3)$$

4.3 Variables

The present study analyse the impact of corporate governance disclosure practices on firm performance. Firm performance is measured in three alternative ways that is market performance, operating performance and financial performance. Tobin's Q, Return on Assets (ROA) and Return on Equity (ROE) are considered as a proxy for measuring the market, operating and financial performance respectively.

Tobin's Q measures the market performance of the firm and it is widely used in corporate governance literature (La Porta *et* al.2002; Gompers *et* al.2003). Tobin's Q is calculated by considering market value of equity and book value of debt upon book value of total assets. This takes into account the investors constrained by their perceptions which includes their optimism and pessimism (Ehikioya, 2009; Shan and Mclver, 2011; Kumar and Singh, 2013; Aggarwal et.al. 2016; Arora and Sharma, 2016; Chauhan et.al, 2016 and Mishra and Kapil, 2017). Shan and Mclver (2011) observe that investors should focus on corporate financial reporting to perceive the underlying value. They also argue that use of Tobin's Q complement the idea that markets are influenced by corporate governance reporting practices.

ROA is used to measure the operating performance of the firms (Chauhan et.al, 2016; Akbar *et*.al 2016; Mishra and Kapil, 2017). It is calculated by taking income before extra-ordinary item to book value of total assets. ROA explains how effectively the management has used the assets to earn better return. Hence, superior management practice improves the ROA better. Superior management practices are the result of better corporate governance disclosure practices in the organisation. It is a concrete measure of performance since it is not volatile or vulnerable during the short term. Because most of the assets are difficult to interpose during the short term and the operational performance is always relates to the fundamental strength of the company.

ROE is the measure of financial performance. The existing literature has used ROE as one of the key performance variables (Hart and Ahuja, 1996; Ehikioya, 2009; Arora and Sharma, 2016; Chahal and Kumari, 2013). It is calculated as the ratio of net income to shareholder's funds. ROE has an investor's focus and concentrated on shareholders return. A high ROE company can raise more cash internally. Hence, they can utilise the different profitable reinvestment opportunity consistently in the future. An improved corporate governance disclosure practice improves the cash management and reduces the agency conflict in the organisation.

The explanatory variable, Corporate governance scores, is computed based on corporate governance disclosure practices. The corporate governance score is a hand-picked data collected from annul reports of the companies. The CG scores are assigned as per the Clause 49 of the listing agreement, Securities Exchange Board of India (SEBI). In India, all the listed companies are mandated to comply with the Clause 49 listing agreements of SEBI with effect from 1st January 2006. As per Clause 49, the corporate governance index score is derived based on seven sub-components such as Board of Directors, Audit Committee, Subsidiary Companies, Disclosures, CEO/CFO Certification, Report on Corporate Governance and Compliance as described by SEBI. Each of the variables is allotted with certain scores out of aggregate of 100 (see Appendix I for details).

For the purpose of examining the impact of corporate governance on firm performance, some of the variables such as leverage, size, yield and age are considered as control variables (see the **Table 1**). Leverage is calculated by using the total borrowings to net worth (Kumar and Singh, 2013; Mishra and Kapil, 2017; Aggarwal *et al*, 2016). The size variable is calculated by taking the natural logarithm of total assets (Sarkar and Sarkar, 2000; Kumar, 2004; Black and Khanna, 2007; Dharmapala and Khanna, 2008; Balasubramanian *et al.*, 2010). The yield variable indicates the earning measure and calculated based on the ratio of dividend to market value of Equity (Aggarwal *et al*, 2016). Age is calculated based on number of years from the date of listing (Ehikioya, 2009; Kumar and Singh, 2013; Aggarwal *et.al*, 2016; Arora and Sharma, 2016 and Mishra and Kapil, 2017).

Table: 1 Description of Variables	
Variable	**Description**
Corporate Governance Score (CG score)	It is calculated from annual report of the companies based on the disclosures made, as per Clause 49 of the listing agreement, SEBI.
Tobin's Q (TQ)	Market value of equity plus book value of debt divided by total assets
ROA	Income before extra-ordinary item to book value of total assets.
ROE	Ratio of profit after tax to Net worth
Size	Logarithm value of Total Assets
Leverage	Ratio of borrowings(Long Term Debt) to Net worth
Yield	Ratio of dividend to market value of Equity
Age	Number of years from the date of listing

5. Results, Analysis and Discussions:

Table 2 shows the descriptive statistics for all the variables considered for analysis. It is observed that median CG score of sample companies is 83 out of 100. Whereas, it is found that maximum CG score is 98 out of 100. This difference raises the concern for the regulators, managers and investors. The mean value for Tobin's is 2.505 with a standard deviation of 2.386. The mean value for Return on Assets is 0.099 with a standard deviation of 0.082. The average value of Return on Equity is 0.194 with a standard deviation of 0.285. This indicates that the market based performance measure has more variability than the financial and operating performance variables. The average age of sample firms is 14.177 years.

Table: 2
Descriptive Statistics

	Mean	Median	Standard Deviation	Minimum	Maximum	Count
TQ	2.505	1.682	2.386	0.000	16.339	440
ROA	0.099	0.081	0.082	-0.336	0.363	440
ROE	0.194	0.162	0.285	-1.586	3.627	440
CG	81.368	83.000	12.923	4.000	98.000	440
Leverage	0.548	0.274	1.030	-6.689	10.370	440
Size	12.396	12.364	1.345	0.000	15.337	440
Yield	1.374	1.120	1.250	0.000	9.800	440
Age	14.177	15.000	5.436	0.000	22.000	440

Table 3 presents the correlation matrix among all the variables. It is observed that there is no multi-collinearity problem among the select variables. Though, the Tobin's Q shows a positive correlation with Corporate Governance score, it has a negative correlation with all other control variables such as leverage, size, yield and age.

Table: 3 Correlation Matrix								
	TQ	*ROA*	*ROE*	*CG*	*Leverage*	*size*	*Yield*	*Age*
TQ	1.000							
ROA	0.625	1.000						
ROE	0.419	0.439	1.000					
CG	0.049	-0.015	-0.146	1.000				
Leverage	-0.085	-0.237	-0.370	-0.188	1.000			
Size	-0.204	-0.128	-0.140	0.158	0.064	1.000		
Yield	-0.067	0.232	0.138	-0.049	-0.131	0.175	1.000	
Age	-0.079	-0.056	-0.075	0.304	-0.194	0.122	0.201	1.000

Table 4 specifies the combined results of Fixed- Effect of GLS Regression analysis for Tobin's Q ratio, Return on Assets and Return on Equity. The total observations are 440 which represent 40 non-financial companies for a period of 11 years. The market, operating and financial performance is measured based on Tobin's Q ratio, return on assets and return on equity respectively. First, we examine the impact of corporate governance disclosures on firm's market performance. It is hypothesised that corporate governance disclosures have positive impact on market performance of the firms. The results indicate that the coefficient value of corporate governance score is positive (0.014) and significant at ten per cent level. It indicates that the corporate governance disclosures have a positive and significant impact on the market performance of the firm. The results are in line with the existing literature (Klapper and Love, 2004; Black et al, 2006; Garay et al, 2008; Chahal and Kumari, 2013; Kumar and Singh, 2013; Akbar et al, 2016 and Chauhan et al, 2016). Thus, based on the empirical results, the hypothesis (H1) is proved. The control variables such as yield and age show a negative and significant impact on Tobin's Q at one per cent level. The variable leverage has a positive association with the Tobin's Q at one per cent level of significance.

Secondly, we examine the impact of corporate governance disclosures on firm's operating performance. Based on the extant literature, the ROA is used as a proxy for measuring the operating performance (Ehikioya, 2009; Chahal and Kumari, 2013; Chauhan *et*.al, 2016; Arora and Sharma, 2016 and Mishra and Kapil, 2017). It is hypothesised that CG score has a positive impact on ROA. The improved corporate governance disclosures create a better transparency in firms operations. It reflects the effective utilisation of the assets by the management. The good corporate governance results better revenue generation and reduction in cost. Among the existing literature, Ehikioya (2009) have found that there is positive and significant association between corporate governance variable and ROA in the Nigerian context. In the case of India, Chahal and Kumari, (2013), Arora and Sharma (2016) and Chauhan *et* al (2016) report that the corporate governance has a positive influence on the performance. In the present study, the empirical results indicate that corporate governance disclosures score has positive but not significant impact on the operating performance of the firms. Hence, the hypothesis (H2) is not proved. The control variable leverage has a positive and significant relationship with ROA. The variable age has negative and significant impact on ROA.

Finally, we examine the impact of corporate governance disclosures on the financial performance the firms. Based on the extant literature, the ROE is used as a proxy for measuring the financial performance. It is hypothesised that CG score has positive impact on ROE. The empirical results indicate that the CG score has a negative (-0.005372) and statistically significant at one percent level. It implies that corporate governance disclosures have a negative impact on ROE. This finding may be specific to India which requires further investigation. However, the results are in line with some of the existing literature (like Ehikioya, 2009 and Arora and Sharma, 2016). Thus, based on the empirical results, the hypothesis (H3) is not proved. Among the control variables, the leverage shows a negative and significant impact on ROE at one per cent level. The age variable shows negative and significant with ROE at five per cent level, which indicates that the younger firms are offering higher return to shareholders.

Table: 4
Impact of corporate governance on firm performance – Fixed Effect Regression model

	Tobin's Q	*ROA*	*ROE*
CG	0.014*** (1.872)	0.000 (0.831)	-0.005* (-4.711)
Leverage	0.318** (3.675)	0.004*** (1.748)	-0.115* (-9.107)
Size	-0.010 (-0.122)	-0.003 (-1.217)	-0.019 (-1.512)
Yield	-0.400* (-5.239)	0.000 (0.137)	0.005 (0.488)
Age	-0.120 * (-4.821)	-0.006* (-8.861)	-0.007** (-2.027)
Number of observations	440	440	440
Adjusted R^2	0.62	0.72	0.43

(* indicate the level of significance at *=1%, **=5%, ***10% respectively); Values in the parenthesis are t statistics

6. Conclusions

The present study made an attempt to examine whether corporate governance disclosure practices has any impact on firm performance in India. Unlike most of the existing studies, the corporate governance score (CG score) is computed based on Clause 49 of listing agreements of SEBI for a long period of time that is 2006-2016. In India, compliance to Clause 49 of SEBI is made mandatory since 2006. CG scores data is handpicked based on the disclosures made under corporate governance section of annual reports of S&P CNX Nifty 50 companies. The firm performance is measured in three alternative ways that is market, operating and financial performance based on Tobin's Q ratio, return on equity and return on assets respectively. The empirical results indicate that CG score has a positive and significant impact on firm performance. The results advocate that companies that comply with regulatory requirements can expect to achieve higher performance. Alternatively, it implies that good corporate governance practices lead to reduced regulator's scrutiny. The results also indicate that CG disclosures have negative and significant impact on financial performance. This observation may be specific to India which needs further investigation based on the structure and composition of the corporate boards. These findings have implications for policy makers, researchers, managers, analysts and investors in general and those in emerging markets in particular.

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Appendix 1: CLAUSE 49 OF LISTING AGREEMENT

	Disclosures	Clause of Listing agreement	Score
I	**Board of Directors**	**49(I)**	**30**
(A)	Composition of Board	49(IA)	8
(B)	Non-executive Directors' compensation & disclosures	49 (IB)	4
(C)	Other provisions as to Board and Committees	49 (IC)	14
(D)	Code of Conduct	49 (ID)	4
II	**Audit Committee**	**49(II)**	**15**
(A)	Qualified & Independent Audit Committee	49 (IIA)	3
(B)	Meeting of Audit Committee	49 (IIB)	2
(C)	Powers of Audit Committee	49 (IIC)	3
(D)	Role of Audit Committee	49 II(D)	3
(E)	Review of Information by Audit Committee	49 (IIE)	4
III	**Subsidiary Companies**	**49(III)**	**10**
IV	**Disclosures**	**49(VI)**	**35**
(A)	Basis of related party transactions	49(IV A)	10
(B)	Board Disclosures	49 (IV B)	4
(C)	Proceeds from public issues, rights issues, Preferential issues etc.	49 (IV C)	4
(D)	Remuneration of Directors	49 (IV D)	4
(E)	Management	49 (IV E)	9
(F)	Shareholders	49 (IV F)	4
V	**CEO/CFO Certification**	**49 (V)**	**3**
VI	**Report on Corporate Governance**	**49(VI)**	**3**
VII	**Compliance**	**49(VII)**	**4**
	Total Score		**100**

Source: Securities Exchange Board of India (SEBI), India

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