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Corporate Governance and Corporate Profitability: Are they Related? - A Study in Indian Context

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Abstract - In today's era of globalization, the corporate world requires a world-class governance system. Corporate governance is about promoting corporate ethics, fairness, transparency and accountability. In recent years, the area of corporate governance has been in limelight and has attracted increased attention of academicians and researchers worldwide due to high-profile scandals and corporate collapses like Enron, WorldCom and Satyam. Despite the intuition that 'Good Governance' would lead to 'Good Performance' by firm, conclusive evidence on this relationship has been lacking. A large number of researches have been done in different parts of the world to study this relationship but the results have been mixed and inconclusive. In this paper, we attempt to find answer to the research question – "Are Corporate Governance and Corporate Profitability Related?" in short term, particularly in an Indian context. We also endeavor to determine the direction of causality between them. We use an initial sample of 50 Indian companies listed on S&P CNX Nifty 50 Index. We use two sets of secondary data (governance ratings and corporate profitability variables) over a period of three years from FY 2010-11 to FY 2012-13 in our analysis, while controlling for size of firm. We also control for sustainability performance of firm, i.e. Environmental, Employee and Community-related performance. The governance and sustainability ratings data has been obtained from 'CSRHub database', while the financial data has been taken from companies' websites, annual reports, financial statements and 'moneycontrol.com'. We apply a series of statistical tools like descriptive statistics, multiple regression, correlation and tests of significance (t-test and F-test). We find that governance rating has a positive but insignificant impact on corporate profitability of firm. Further, we find that corporate profitability also has an insignificant positive impact on governance rating of firm. But the given study suffers from some limitations and the results must be interpreted and used in light of these limitations.

***Index Terms* -** Business ethics, corporate collapses and scandals, corporate financial performance, corporate governance, corporate profitability, corporate sustainability, Global Reporting Initiative (GRI).

I. INTRODUCTION

Corporate governance is the set of processes, customs, policies, laws and institutions, affecting the way a company is directed, administered or controlled. The Cadbury Committee of U.K. in January, 2000 defined corporate governance as – "the system by which companies are directed and controlled" (Cadbury, 2000). It also includes the relationships among the various stakeholders (e.g. members/shareholders, management and board of directors) involved and the goals for which the corporation is governed.It refers to leadership structure and values that determine corporate direction, ethics and performance. The aim is to align as nearly as possible the interests of individuals, corporations and society. It focuses on how management is committed to sustainability and corporate responsibility at all levels.

It is an indisputable fact that scams and scandals are increasingly undermining our lives. In recent years, the area of corporate governance has received increased attention because of striking high-profile scandals and corporate collapses worldwide such as Enron (US), WorldCom (US), Maxwell Pension Scandal (UK), Satyam and Reebok (India), etc. involving unethical conduct, abuse of corporate power and alleged criminal activity by key managerial personnel. The recent 2007-08 collapse of the subprime mortgage markets further highlighted the importance of good governance. An integral part of an effective corporate governance regime includes provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the corporation. The proper governance of companies is as crucial to the world economy as the proper governing of countries.

A large number of studies in past have examined the relationship between corporate governance and corporate financial performance, but the results have been mixed and inconclusive. Eccles et al. (2012) recommended that for sustainability to be embedded in the organizational culture, the governance structure needs to be tailored accordingly. They emphasized on the significance of two key elements of Corporate Governance, i.e. Board of Directors (BOD) and Executive Compensation, to ensure sustainable growth of the organization. In this paper, we examine and analyze the relationship between corporate governance and corporate profitability in short run in an Indian context.

II. OBJECTIVES OF THE STUDY

The objectives of this study are as follows:

- To provide an overview of the concept of corporate governance.
- To present a brief review of literature through survey of important previous researches establishing a relationship between corporate governance and corporate financial performance.
- To empirically study the relationship between corporate governance and corporate profitability over short term in an Indian context.
- To determine direction of causality in the given relationship.

III. CONCEPT OF CORPORATE GOVERNANCE

As per Report of the SEBI Committee on Corporate Governance, February 2003 - the fundamental objective of corporate governance is to enhance the long-term shareholder value, while at the same time protecting the interests of other stakeholders by improving the corporate performance and accountability (SEBI, 2003). Corporate Governance lays down the framework for creating long-term trust between companies and the stakeholders. Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. SEBI believes that companies having good corporate governance system in place are rewarded by investors and markets with high valuations. In practice, there are four principles of good corporate governance, which are: (1) transparency; (2) accountability; (3) responsibility; and (4) fairness (Aras &Crowther, 2008).

The companies are required to disclose their governance structure in their corporate reports. The Standard Disclosures under Governance Aspect as per G4 Sustainability Reporting Guidelines by Global Reporting Initiative (GRI) include:

- Governance Structure and its Composition;
- Role of highest governance body in setting organization’s purpose, values, and strategy;
- Competencies and Performance Evaluation of highest governance body;
- Role of highest governance body in Risk Management;
- Role of highest governance body in Sustainability Reporting;
- Role of highest governance body in evaluating Sustainability Performance;
- Remuneration and Incentives (Global Reporting Initiative, 2013).

The quality of corporate governance primarily depends on the following factors, which consequently affect the corporate performance:

- Integrity of management
- Size of Board (the larger the board, the better it is)
- Ability of board, qualifications/expertise and commitment of board members

- Frequency of Board Meetings
- Insider Trading and Whistle Blower Policy
- Quality of corporate reporting
- Stakeholder Engagement (participation of stakeholders in management)
- Independent Directors (protect overall organizational and stakeholders interest)
- Board Committees - Audit Committee, Remuneration Committee, Nomination Committee, Investor Grievance Committee, Risk Management Committee, etc.
- Class Action Suits
- Role and Rotation of Auditors

IV. LITERATURE REVIEW

Considerable theoretical, review and empirical researches have been done globally to study the relationship between governance and corporate performance. Although broadly the conclusion has been that 'Good Governance Does Pay" (Eisenhofer, 2010), but conclusive evidence linking good governance to good performance has been lacking and the existing studies have yielded mixed results (Pande, 2011). Also, the conclusiveness of studies varies across countries (Mani &Sreedharan, 2004).

Gompers et al. (2003) performed their study using governance index for 1500 large US firms, and found that the risk-adjusted returns of firms with strong governance were 8.5% higher than firms with poor governance. **Brown and Caylor (2004)** found positive association between corporate governance scores (after adjusting for industry effects) and financial performance of firm (based on dividend payout, yield, profitability and shareholder returns). One of the key findings of **Mani and Sreedharan (2004)**, a study conducted by CRISIL Ratings in Indian context over a 3 years period was that superior governance practices of firm are positively and significantly correlated to market valuation of firm. **Van de Velde et al. (2005)** observed that portfolios with above-average governance scores outperformed the portfolios with below-average governance scores. **Governance Metrics International and Byun (2006)** found that companies with higher governance ratings enjoyed higher profits and returns. **Ashaugh-Skaife and Lafond (2006); Derwall and Verwijmeren (2007)** analyzed the linkage between Governance Metrics International (GMI) governance ratings and the firm's cost of equity capital. They suggested that firms with higher governance scores demonstrate lower risk to investors, and thus, enjoy lower cost of capital. **Sachs (2007)** suggested that investments in highly governed companies significantly outperform the investments made in poorly governed companies. **Balasubramanium et al. (2008)** found a positive and statistically significant association between their overall India Corporate Governance Index (ICGI) and Tobin's Q value (used as proxy for market value of firm) and further this association was stronger for more profitable firms and firms with higher growth prospects. **Selvaggi and Upton (2008)** commented on direction of causality and stated that good governance causes good firm performance, rather than vice versa.

However, **Mukherjee and Ghosh (2004)** portrayed a dismaying scenario and concluded that corporate governance in India is still in a young and developing stage and that the investment decisions of Indian investors are volatile, not based on governance practices of firms. **Chidambaram et al. (2006)** found no significant performance difference between firms with good governance changes and firms with bad governance changes and thus, rejected the hypothesis that better governance leads to better financial performance. This result is consistent with those of **Core et al. (2006);** and**Statman and Gluskhov (2009)**, who found no significant relationship between corporate governance and firm performance. **Azim (2012)** observed that different governance elements have varying impact on corporate performance and profitability. TABLE – 1 given below summarizes the findings of literature review on this relationship.

TABLE – 1: Relationship between Corporate Governance and Corporate Financial Performance

S. No.	Study	Relationship
1.	Gompers et al. (2003)	Positive, but not significant
2.	Brown and Caylor (2004)	Positive
3.	Mani and Sreedharan (2004)	Positive and Significant over 3 years period
4.	Mukherjee and Ghosh (2004)	Not Significant
5.	Van de Velde et al. (2005)	Positive, but not significant

S. No.	Study	Relationship
6.	Chidambaram et al. (2006)	Not Significant
7.	Core et al. (2006)	Not Significant
8.	Governance Metrics International and Byun (2006)	Positive
9.	Sachs (2007)	Positive and Significant
10.	Balasubramanium et al. (2008)	Positive and Significant
11.	Selvaggi and Upton (2008)	Positive and emphasizes one way causality
12.	Statman and Gluskhov (2009)	Not Significant
13.	Eisenhofer (2010)	Positive
14.	Pande (2011)	Mixed and Inconclusive
15.	Azim (2012)	Mixed results
16.	Aggarwal (2013)	Positive and Significant over 2 years period

The above table shows mixed and inconclusive results on the relationship between corporate governance and financial performance. Thus, we empirically test this relationship in the given paper in an Indian context.

V. HYPOTHESIS

On the basis of theory and literature review and keeping in view the research objectives, we have formulated the following **two hypotheses:**

Ho1: Governance rating of company has no impact on its profitability.

Ha1: Governance rating of company has an impact on its profitability.

Ho2: Corporate profitability has no impact on governance rating of company.

Ha2: Corporate profitability has an impact on governance rating of company.

VI. RESEARCH METHODOLOGY

Statistical tools such as descriptive statistics and regression have been applied using Microsoft Excel to study the relationship between corporate governance and corporate profitability using secondary data. The average data over a period of three years from FY 2010-11 to FY 2012-13 has been used to enable cross-sectional analysis.

6.1 SAMPLE SELECTION

The criterion for sample selection is as follows:

Companies listed on S&P CNX Nifty 50 Index as on 31st March, 2013 =	50
Less: Banks and Financial Companies =	10
Less: Companies whose annual financial data as on 31st March is not available =	04
Less: Companies whose required governance data is not available =	02
Final Sample =	**34**

Thus, the final sample consists of 34 Indian non-financial companies, which are listed on the NSE as on 31st March, 2013 and whose required financial and governance ratings data is readily available.

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6.2 VARIABLES AND DATA SOURCES

This paper uses two sets of secondary data. The financial data consists of four measures of corporate profitability - Return on Assets (ROA), Return on Equity (ROE), Return on Sales (ROS) and Return on Capital Employed (ROCE). The financial data has been obtained from companies' website, reports and 'moneycontrol.com'. The governance ratings of companies have been used as proxy for corporate governance performance quotient. Also, the study uses certain control variables which may have effect on the company's governance structure and this relationship. These are - size of firm (as proxied by natural log of total assets), and environment, community and employee-related sustainability performance of companies. "CSRHub database", which claims to be world's largest corporate sustainability ratings database and principally adheres to GRI guidelines, has been used to obtain the governance, community, employee and environment ratings data. The governance ratings used in this study are based on three parameters - Board, Leadership Ethics and Transparency & Reporting.

6.3 EMPIRICAL MODEL

This study makes use of two empirical models in order to study the relationship between corporate governance and corporate profitability. We apply statistical tools like descriptive statistics and regression using Microsoft Excel. The two models are explained in the following sub-sections.

6.3.1 FIRST MODEL

The first model has been designed to analyze the impact of governance of companies on their profitability. Thus, the independent variable used in this model is governance rating of firm (GOV) and corporate profitability measures - ROA, ROE, ROS and ROCE have been used as dependent variables. Further we have controlled for size of company (SIZE) and company's performance along employees (EMP), community (COM) and environmental (ENV) dimensions. The five regression equations analyzed in this model are as follows:

$$ROA = c + b_1.GOV + b_2.EMP + b_3.ENV + b_4.COM + b_5.SIZE \quad (1)$$

$$ROE = c + b_1.GOV + b_2.EMP + b_3.ENV + b_4.COM + b_5.SIZE \quad (2)$$

$$ROS = c + b_1.GOV + b_2.EMP + b_3.ENV + b_4.COM + b_5.SIZE \quad (3)$$

$$ROCE = c + b_1.GOV + b_2.EMP + b_3.ENV + b_4.COM + b_5.SIZE \quad (4)$$

6.3.2 SECOND MODEL

The second model has been designed to analyze the impact of corporate profitability on the governance rating of firm. Thus, the independent variables used here are corporate profitability measures - ROA, ROE, ROS and ROCE and governance rating (GOV) has been used as dependent variable in this model. The regression equation used is as follows:

$$GOV = c + b_1.ROA + b_2.ROE + b_3.ROS + b_4.ROCE + b_5.SIZE \quad (5)$$

VII. RESULTS

The descriptive statistics for key variables used in this paper have been summarized below in TABLE – 2.

TABLE – 2: Descriptive Statistics

Particulars	ROA (%)	ROE (%)	ROS (%)	ROCE (%)	GOV (%)
Mean	15.92	21.36	29.79	25.51	**47.48**
Median	13.60	15.28	21.81	16.88	47
Std. Dev.	9.94	18.30	22.86	23.01	7.46
Observations	34	34	34	34	34

From above table, we observe that the mean value for governance rating is 47.48%, which is quite a low rating. Thus, the Indian companies should strive to improve their governance by emphasizing on ethics, transparency and accountability, so as to achieve higher ratings. Now, the results of first model have been summarized in TABLE – 3 below.

TABLE – 3: Results Summary for First Model

Particulars	R	R^2	Adjusted R^2	F	Significance of F	Beta Coefficient for GOV (b_1)	p-value
ROA	.489	.239	.103	1.760	.154	0.424	.281
ROE	.434	.188	.043	1.298	.293	0.076	.918
ROS	.435	.189	.044	1.305	.290	2.229	**.021***
ROCE	.414	.171	.023	1.156	.355	0.120	.898

* Significant at 5% level of Significance

Now, the results of second model showing impact of corporate profitability on governance rating have been summarized in TABLE – 4 below.

TABLE-4: Second Model Summary

Particulars	Coefficients	p-value
ROA	0.404	0.125
ROE	-0.124	0.746
ROS	0.031	0.615
ROCE	-0.046	0.891
SIZE	1.666	0.280

R	0.406
R Square	0.165
Adjusted R Square	0.016
F	1.105
Significance of F	0.380

VIII. FINDINGS AND CONCLUSIONS

The key findings of first model that can be inferred from TABLE-3 are as follows:

- All the correlation coefficients (R) are positive and approximately close to 50%. Thus, there is positive correlation between corporate governance and corporate profitability.
- All the beta (b_1) values are positive. Thus, governance rating has positive impact on corporate profitability.
- Further, we find that only p-value in case of Return on Sales (ROS) is significant at 5% level of significance, since .021 is less than .05. Thus, Governance rating of company has a significant impact on ROS, but not on other three profitability measures.
- Overall, we may conclude that corporate governance has positive but not significant impact on corporate profitability. Hence, we do not reject the first null hypothesis (Ho1).

The key findings of second model that can be inferred from TABLE-4 are as follows:

- The correlation coefficient (R) 0.406 shows that association between corporate governance and profitability is positive and 40.6%.
- The beta coefficients show that ROA and ROS positively impact governance rating of company, while ROE and ROCE have negative impact.
- Further, none of the p-values in less than 0.05.

- Thus, we may conclude that corporate profitability has no significant impact on governance rating of company. Hence, we do not reject the second null hypothesis (Ho2).

This paper attempts to analyze the relationship and to establish the direction of causality between corporate governance and corporate profitability. But we do not find any evidence to suggest significant relationship between them. Our conclusion that corporate governance has positive impact on corporate profitability in short term supports existing research results of Mani and Sreedharan (2004); Aggarwal (2013), but with a difference that they suggested significant relationship, while our results suggest no significant association.

Also the Indian companies should improve the way in which their companies are governed by taking care of the interest of various stakeholder groups and by emphasizing on qualified and independent directors, business ethics, transparency and fairness in corporate disclosures, whistle blower protection mechanism and accountability.

IX. LIMITATIONS OF STUDY

This paper suffers from some limitations which should be addressed by the future researchers:

- Limited sample size
- Short frame of research
- Market-based measures such as share prices, stock returns, market value of firm, etc have been ignored.
- Various control variables (e.g. firm's age, growth, leverage, risk, R&D, industry, etc.) have not been incorporated in our analysis.
- Corporate governance is a vast concept and is difficult to measure with objectivity and hence measure used in this study may be subjective and not a comprehensive measure.

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