

Firm-Level Corporate Governance in Emerging Markets: A Case Study of India



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Corporate Governance and Firm Performance in India?”,
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Projects on Corporate Governance in India

- Study evolution of Indian Corporate Governance over time.
 - How do governance practices affect firm behavior and value?
 - How do firm characteristics affect firms' governance choices – should governance vary across firms to an extent?
 - Which “good governance” prescriptions matter, which don't?
- Series of papers examining this and related issues:
 - Khanna (2008a, 2008b, 2008c)
 - Khanna & Kraakman (2008)
 - Black & Khanna (2007)
 - Khanna & Dharmapala (2008)
- ***This paper (snapshot of Indian governance in 2006).***
- Annual surveys of Indian governance → time series research on above noted questions.
- Policy implications for India

Overview of this Paper

- Corporate Governance (CG) Survey of Indian firms. Response rate is very high and sample seems a good representation of Indian firms. Compliance with laws is generally good, though there is room for improvement.
- Connection between CG and firm value in India.
 - Better CG is associated with higher firm value (Tobin's Q between 7 to 11% higher with better CG).
 - Association of CG with firm value depends on type of firm (e.g., size, industry, ownership structure). Influence policy development?
- What parts of CG matter most?
 - Disclosure and Shareholder rights. Other parts of CG less significant.
- Recommendations plus Questions for further thought.

Literature Review & Background



- Prior Knowledge on CG patterns at the Firm Level - little known about this.
 - Our paper provides a detailed description of Indian CG.
- CG predict firm performance (or share price)?
 - Many cross country studies, but limited list of CG factors.
 - Our paper provides results on the association between CG and firm performance in India at a fairly detailed level.
- Background to CG reforms in India
 - Prior to 1991 CG was quite weak in India
 - Post 1991 Liberalization started and by 1998 CG reforms were being discussed actively.
 - 1998 to 2005 significant reforms. Clause 49 watershed event.

Description of India CG Survey

- We approached 506 Indian firms in six major metros in 2006 with a detailed 15 page survey questionnaire. Survey support from BSE and funding support from GCGF and home academic institutions.
- Response rate was 73% (370 firms) and 96% of these responses (361 firms) came from the CEO, CFO or Company Secretary.
- We focus on Private Indian Firms which represent 301 of the 370 responding firms. The remaining 69 firms are 38 foreign firms and 31 government controlled firms.
- Additional sources of information: websites, Prowess & annual reports.
- Are we getting a representative sample of Indian firms? We think so....

Surveyed & Responding Firms – Sample Selection

Size Group	Number of Firms			Market Capitalization		
	No of. firms	Surveyed (% of total)	Responded (% of surveyed)	Market cap (all firms)	Surveyed (% of total)	Responded (% of surveyed)
BSE 30	30	26 (87%)	77%	1,216	95%	73%
BSE 31-100	70	45 (64%)	58%	537	71%	62%
BSE 101-200	100	61 (61%)	51%	229	57%	54%
BSE 201-500	300	142 (47%)	56%	276	50%	53%
<i>Subtotal BSE 500</i>	500	274 (55%)	58%	2,258	80%	68%
Other	2,007	232 (15%)	91%	202	29%	74%
Total	2,507	506 (20%)	370 (73%)	2,459	76%	68%

- Capturing 76% of Indian Market Capital.
- Broad cross section of Indian business (Tables 4 – 6).
- Firms approached are fairly similar to those that were not approached (Table 2).
- Responding firms are fairly similar to the non-responding firms (Table 3).
- Responses seem quite reliable – match annual reports, from knowledgeable high level executives and sometimes indicate *non-compliance* with the law.

Survey Results – Board Structure

Percentage range	Inside	Nonexecutive (not independent)	Independent	Separate CEO and Chair (%)
0%	7	152	7	2
1-32%	121	97	13	9
33-49%	98	31	68	50
50%	35	4	70	34
51-74%	31	9	108	67
75-100%	3	2	29	13
Total	295	295	295	175 (59%)

- Clause 49 minimum requirement: 1/3 independent directors
 - 257 of responding firms (87%) comply
 - 20 firms (7%) do not comply with 1/3 standard
 - 18 firms (6%) have 33-49% independent, but same CEO and chair

Survey Results – Board Practices & Processes

Characteristics & Summary of Results	
Director Terms	Most directors have multi-year terms and they are often staggered.
Board Meetings	Almost all firms have at least 4 physical meetings a year – non-physical less common .
Committee Minutes	Almost all firms prepare committee minutes
Evaluation of CEO & other executives and directors	Most firms have a system for evaluating (i) executives (83%), (ii) some for CEO (51%) and (iii) few for nonexecutive directors (25%).
	Few firms have a succession plan for the CEO (29%).
	No firms replaced CEO (last 5 years) and dismissals of other executives/directors rare.
	Separate meetings for nonexecutive directors not common.
Other	Code of conduct and policy restricting insider trading very common (90% plus).
	Board receives materials for meetings at least one day in advance (96%), but board training uncommon.

- Overall, process is quite good and high compliance with many features.
- However, evaluation and oversight of CEO and other executives seems weak.

Survey Results – Audit Committee

Characteristic	Firms without characteristic
Existence and membership	
audit committee exists	3
If audit committee exists	
does it have at least 3 members (average number is 3.6)	3
does it have at least one member with expertise in finance or accounting	1
Powers & Processes	Firms with characteristic
recommends external auditor to full board	196 (65%)
independent members meet separately at least once/year	215 (72%)
audit committee meets at least 4 times a year	227 (79%)

- Virtually all firms have an audit committee with the required expertise.
- However, the powers of the audit committee seem somewhat constrained.
- Room for improvement.

Survey Results – Executive Compensation

Characteristic	Responses	Mean (Median)
Overall Executive Compensation		
Level requires gov't approval under Companies Act	52 (17%)	
CEO cash compensation (lakhs, 1 lakh ~\$2,200)	251	64 (30)
Compensation of all other executives	184	2273 (154)
Stock Options		
Executives receive stock options	49 (16%)	
Disclosure and Shareholder Approval		
	Disclosed	Approved
CEO total pay	286	267
total pay of non-executive directors	231	183
total pay of all directors	267	211

- Overall picture: compensation is not out of control (unlike U.S.)
- Explicit requirement for approval of CEO pay would still be useful.

Survey Results – Related Party Transactions

Characteristic		Firms	
RPTs disclosed to shareholders		275 (94%)	
firm requires RPTs to be on arms-length terms		230 (78%)	
RPTs are $\geq 1\%$ of revenues		142 (67%)	
RPTs are $\geq 5\%$ of revenues		42 (20%)	
Nature of RPT approval		w. inside director	w. controlling shareholder
no specific requirement		81	102
approval by board of directors		212	182
approval by non-conflicted directors		26	20
approval by non-conflicted shareholders		2	3

- RPTs are common and usually disclosed.
- Approvals by non-conflicted parties not common.
- Approval by non-conflicted directors should be a minimum.
- Room for improvement here.

Survey Results – Shareholder Rights

Characteristic	Firms with characteristic	mean (median)
shareholders can vote by postal ballot	218 (73%)	
percentage of shares voted at most recent AGM		58% (60%)
company had shareholder resolution in last 5 years	52 (17%)	
disputes w. shareholders resolved by arbitration	20 (7%)	
shareholders requested extraordinary meeting in last 5 years	14 (5%)	
shareholders asked SEBI or Tribunal to investigate oppression within last 5 years	1	

- The low rate of voting and significant non-compliance with postal ballots raises concerns.
- Also, few firms appeared to provide takeout rights.
- Room for improvement.

Survey Results - Disclosure

Disclosure	Yes (%)
Financial Information (on the web)	
Annual financial statements	187 (68%)
Quarterly financial statements	203 (73%)
Annual report to shareholders	142 (51%)
Directors' report	148 (53%)
Corporate Governance Report (on the web)	153 (55%)
Cross Listed Firm	22 (7%)
Cross listed in Europe: London (12), Luxemborg (11), Frankfurt (5), and Berlin (5)	
Cross listed in the US: US-OTC (6) and US-NYSE (4)	
Company officers hold regular meetings with analysts	188 (62%)


- Disclosure, when provided, is generally very good.
- However, sometimes not so easy to obtain the reports.
- Meetings with analysts is fairly good, though could improve.

Survey Results – Since When Have CG Practices Been Adopted?

Practice	Usable Responses	Since When		
		2000s	1990s	Earlier
When was company incorporated	298	6	83	209
Separate CEO and chairman	163	46	57	60
Regular system for evaluating CEO	137	71	43	23
Regular system for evaluating other execs	205	92	70	43
retirement age for non-exec directors	44	0	0	44
code of conduct	266	246	13	7
policy restricting insider trading	251	218	37	6
audit committee recommends external auditor	180	149	24	7
auditor provides non-audit services	111	52	45	14
executives receive stock options	48	39	7	2
RPTs on arms-length terms	185	111	31	43
RPTs are disclosed to shareholders	224	170	31	23

- Many changes to governance have arrived after Clause 49.

Survey Results - Enforcement



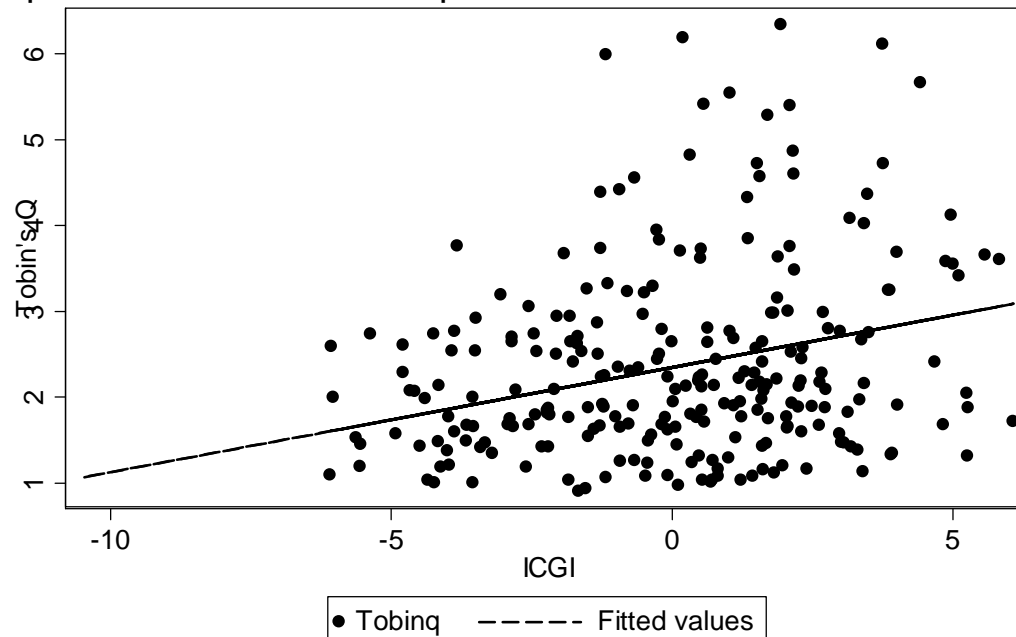
Enforcement action by Tribunal (last 5 years)	Type of Firm		
	Indian Private	Government	Foreign
Removed director or blocked director from serving	1	0	1
Dismissed CEO	0	0	0
Dismissed another executive	0	1	0
Ordered special audit	3	0	0

Does CG Predict Firm Value in India?

- Developing the Indian CG Index.
- Use Survey Responses to identify 49 firm attributes that varied sufficiently amongst firms and were associated with good CG. Equal weighting per attribute.
- Categorize responses into those relating to Board Structure, Disclosure, RPTs, Process and Shareholder Rights (Table 21).
- Results suggest... .

Does CG Predict Firm Value in India? Simple Correlation

Scatter plot of overall Indian Corporate Governance Index ICGI without outlier



coef = 0.122, t-value = 4.87, corr = 0.2550, obs = 267, 10 outliers are dropped

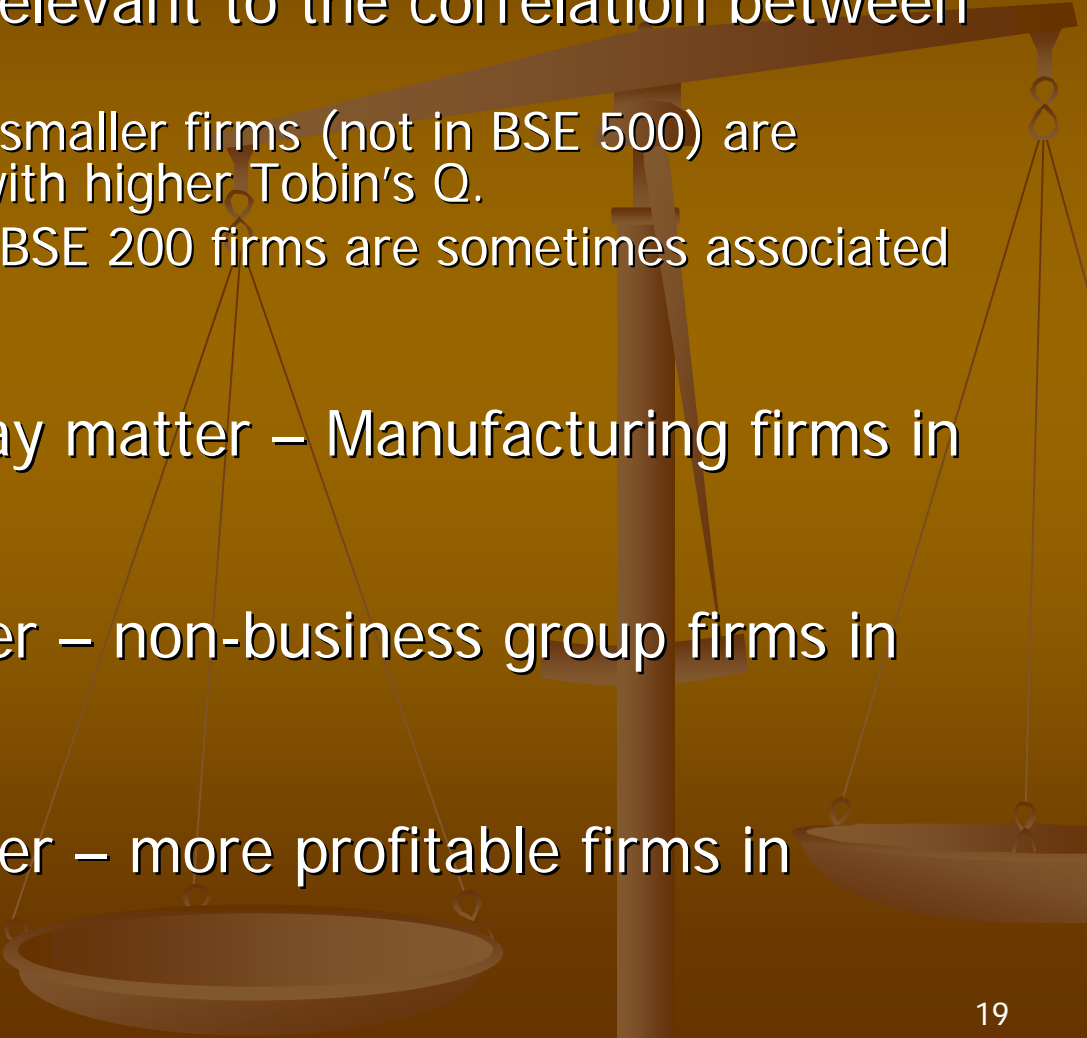
There does appear to be a correlation between Corporate Governance and Firm Value.

Are these results robust when we consider other things that may influence firm value? Yes (Table 24).

Does CG Predict Firm Value in India? Are the Results Robust?

	Dependent Variable	(Tobin's Q)
Overall Index (<i>ICGI</i>)	0.113* (3.85)	0.0687** (2.39)
Log of book value of assets (size measure)		-0.158** (-2.12)
Sales Growth		0.0881* (1.69)
R&D/Sales		13.24*** (3.03)
Advertising/Sales		10.97*** (3.03)
Exports/Sales		0.327* (1.82)
Capex/Sales		-0.251*** (-2.66)
PBDIT/Sales		2.299*** (3.87)
Foreign Ownership		0.0275*** (3.67)

Does CG Predict Firm Value in India? Is the association consistent across firms?

- Size of firm appears relevant to the correlation between ICGI and firm value.
 - Higher ICGI scores at smaller firms (not in BSE 500) are generally associated with higher Tobin's Q.
 - Higher ICGI scores at BSE 200 firms are sometimes associated with higher Tobin's Q.
 - Industry Grouping may matter – Manufacturing firms in particular.
 - Ownership may matter – non-business group firms in particular.
 - Profitability may matter – more profitable firms in particular.
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Does CG Predict Firm Value in India? Subsample Results

	Dependent	Variable (Tobin's Q)	
	Sample size	ICGI (with no controls)	With Controls
Entire Sample	262 (253)	0.113*** (3.85)	0.0687** (2.39)
BSE 200	39 (38)	0.323** (2.09)	0.190 (0.85)
BSE 201 – 500	57 (56)	-0.039 (-0.49)	0.062 (0.75)
Non-BSE 500 firms	166 (161)	0.083*** (2.94)	0.069*** (2.74)
Manufacturing firms	189 (183)	0.114*** (4.15)	0.084*** (3.29)
Non-business group firms	120 (114)	0.143*** (3.32)	0.112*** (2.76)
More profitable firms (measured by ROA)	131 (129)	0.192*** (4.12)	0.153*** (4.08)

Does CG Predict Firm Value in India? What Parts of CG Matter?

- Not all aspects of CG seem to be equally associated with higher Tobin's Q.
- Only Disclosure and Shareholder Rights appear significant, with Shareholder Rights appearing more consistently across different kinds of firms.
- Board Structure, RPTs and Process do not seem significantly associated with higher Tobin's Q.

Does CG Predict Firm Value in India? Subindex Results

	Dependent Variable	(Tobin's Q)
	All Firms (with significant controls)	Is it consistent across types of firms?
ICGI	0.0687** (2.39)	Often significant
Board Structure	0.113 (1.51)	Rarely significant
Disclosure	0.151* (1.84)	Significance weakens
Board Process	0.099 (1.29)	Not significant
Shareholder Rights	0.181*** (2.63)	Generally significant
Related Party Transactions	0.0463 (0.67)	Not significant

Summary



- Compliance with rules is fairly good amongst responding firms, but with room for improvement.
- Better CG is associated with higher Tobin's Q (firm value) generally and for certain types of firms in particular.
- Certain aspects of CG seem to matter more: disclosure and shareholder rights.
- Our results show association, not causation per se. However, as we continue to study this issue it seems there are reasons to think causation is present – stay tuned... .

Likely Recommendations

- Greater disclosure of RPTs and approvals by non-conflicted parties.
- Executive compensation not appear excessive, yet greater disclosure and specific approval of CEO compensation may prove desirable.
- More oversight of CEO and executive performance.
- Greater reliance on audit committee's powers.
- Rules (enforcement) on postal balloting and takeout rights (especially given importance of shareholder rights).
- Generally more enforcement may be merited (eg board structure, disclosure).
- Design policy more explicitly for certain kinds of firms and re-think application of all governance requirements for all firms. It may be optimal to have some variety in governance.
- Focus on aspects of governance that may matter most at this time – e.g., board independence may not be as critical now as shareholder rights and RPTs.

Further Questions & Areas of Research and Policy

- Role of Enforcement – see Khanna (2008a); Khanna & Dharmapala (2008). Alternatives to regulatory enforcement?
- Role of Institutional Investors (especially Foreign Investors) in Indian CG – see Khanna (2008b).
- Role of Extra Legal Actors in Indian CG? Media and general norms of doing business.
- Ownership Structure changes – Khanna & Kraakman (2008). What might this mean for regulation & CG in India?