

Corporate Governance And Investment Decisions

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INTRODUCTION

There has been a growing international focus on Corporate Governance, particularly in the wake of worldwide financial turbulence and scams. The corporate scene all over the world has witnessed significant changes marked by re-structuring, mergers and acquisitions, takeovers, strategic alliances, etc. As a consequence, the issue of public accountability through corporate governance has been brought into sharper focus.

CONCEPT OF CORPORATE GOVERNANCE

As per the Cadbury Committee (May 1991), *“Corporate Governance is a system by which companies are directed and conducted”*.

The Organization for Economic Co-operation and Development (OECD)(2004) presents corporate governance as follows:

“Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. It involves a set of relationships between a company's management, its boards, its shareholders and other stakeholders. CG provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined. Corporate Governance provides proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders.”

Corporate governance is recognized as a crucial element for maintaining the stability and soundness of the financial system. It is about promoting corporate fairness, transparency and accountability.

Owing to the financial collapse in 1980s and early 1990, the London Stock Exchange set up the Cadbury Committee in 1991 for enhancing the role of self-regulation as a measure of controlling the financial collapse. In an attempt to articulate the standards of corporate governance, OECD framed the principles of corporate governance in 1999 and again revised them in 2004 to improve the corporate governance practices. The high profile scandals in USA gave an impetus to the Sarbanes-Oxley Act of 2002.

CORPORATE GOVERNANCE IN INDIA

Corporate Governance has gained importance in India in the wake of economic reforms due to liberalization and deregulation. In April 1998, CII took the lead in framing a voluntary code of desirable corporate governance practices, containing recommendations regarding the composition of the Board of Directors, levels of disclosures, role of audit committee and other related matters, thus enhancing corporate transparency and accountability. In February 2000, SEBI appointed a committee on corporate governance headed by Shri Kumar Mangalam Birla. It suggested a code of corporate governance to be enforced through listing agreements with stock exchanges. As a sequel to the recommendations, a special clause 49 was inserted in the listing agreement. In April 2002, the Department of Company Affairs framed a study group on corporate excellence under the chairmanship of P. L. Sanjeev Reddy for raising governance standards. After the Enron debacle, the Indian government constituted the Naresh Chandra Committee in 2002 for improvement of law relating to auditor-client relationship and the role of independent directors.

SIGNIFICANCE OF THE STUDY

There have been instances of lack of integrity and transparency on the part of regulators, bodies involved in setting up

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accounting standards, rating agencies and other market participants. As a result, investors have lost faith in the financial statements. After the Satyam scandal, investors suffered huge losses. Good corporate governance should aim at bringing the investors back to the market. A need was felt to know the linkages between corporate governance and investment decisions.

REVIEW OF LITERATURE

Most of the literature on corporate governance has focused on the relationship of corporate governance and the firm's performance and in some cases, the literature has focused upon a particular aspect of governance such as board characteristics (Millstein & MacAvoy, 1998 and Bhagat & Black, 1999); shareholders' activism (Karpoff, Malatesta & Walking, 1996 and Carleton, Nelson & Weisbach, 1998); compensation to outside directors (Bhagat, Carey & Elson, 1999); anti-takeover provisions (Sundaramurthy, & Mahoney, 1997).

Klapper and Love (2002) used data of over 400 companies in 25 emerging economies to show that good corporate governance practices are highly correlated with the firm's market valuation.

Lawrence, Brown & Marcus Caylor (2004) concluded that companies which have split the roles of Chairman and CEO perform better than those companies which have the same individual in both positions.

Hollins, Collins & Lafond (2004) investigated whether firms exhibited strong governance benefit from higher credit ratings relative to firms with weaker governance. Chhibber & Majumdar (1998) analyzed the relation between foreign ownership and the company's performance using the accounting measures of the rate of return on assets and return on sales.

Khanna & Palepu (1998) examined the relative efficiency of domestic financial institutions and foreign institutions in the governing business group affiliated companies and non-group companies.

Davis, Schoorman & Donaldson (1997) discussed how government structures along with executive compensation are the two mechanisms which protect shareholders' interest, minimize agency costs and ensure agent-principal interest alignment. Core et al. (1999) suggested that firms with weaker governance structure have greater agency problems; that firms with greater agency problems allow managers to extract greater private benefits; and that firms with greater agency problems perform worse. Specifically, in Asia, it has been shown that both before (Joh 2003) and after (Mitton 2002) the Asian financial crisis in 1997, firms that paid heed to good corporate governance practices fared better and provided greater protection to shareholders, especially the minority shareholders.

In the Asian context, Claessens & Fan (2002) confirmed that the lack of protection of minority rights has been the major corporate governance issue, and it is priced into the cost of capital to the firms. Similarly, Johnson et al. (2000) found evidence that the protection of minority shareholder rights mattered a great deal for the extent of stock market decline during the Asian financial crisis.

RESEARCH METHODOLOGY

A structured questionnaire was administered to the respondents to know their views and the level of importance they attached to corporate governance while investing. Garrett's ranking Test was used to know the key characteristics of good corporate governance and the most desirable characteristic of the BOD from the view point of brokerage firms.

SAMPLE SIZE

30 brokerage firms of India were selected to study their views on corporate governance.

OBJECTIVES OF THE STUDY

- ✿ To know the level of importance brokerage firms attach to corporate governance while taking investment decisions.
- ✿ To know the key characteristics of good corporate governance from the point of view of investors.
- ✿ To know whether there exists a linkage between corporate performance and good corporate governance from the point of view of investors.

LIMITATIONS OF THE STUDY

- ✿ The study is limited to brokerage firms in India only.
- ✿ Answers to the questions depend upon the beliefs of the respondents.

ANALYSIS AND FINDINGS

Table 1: Corporate Governance Vis-a - Vis Financial Growth			
	Frequency	Percent	Cumulative Percent
More imp	11	36.7	36.7
As imp	14	46.7	83.3
less imp	4	13.3	96.7
Not imp	1	3.3	100.0
Total	30	100.0	

Table 2 : Investment In Companies With Poor Corporate Governance, If Financially Attractive			
	Frequency	Percent	Cumulative Percent
Often	9	30.0	30.0
Sometimes	20	66.7	96.7
Never	1	3.3	100.0
Total	30	100.0	

Table 3 : Ready To Pay Higher Premium For Good Corporate Governance			
	Frequency	Percent	Cumulative Percent
Usually yes	13	43.3	43.3
Sometimes yes	10	33.3	76.7
Normally No	3	10.0	86.7
Exceptional	3	10.0	96.7
Never	1	3.3	100.0
Total	30	100.0	

Table 4 : Quantity of Premium			
	Frequency	Percent	Cumulative Percent
10% - 20%	16	53.3	53.3
<10%	6	20.0	73.3
Difficult to quantify	8	26.7	100.0
Total	30	100.0	

Table 5 : Linkage Between Performance And Governance			
	Frequency	Percent	Cumulative Percent
Strong	11	36.7	36.7
Moderate	19	63.3	100.0
No	0	0	
Total	30	100.0	

Table 6 : Role Of Audit Committee In Preventing Fraud			
	Frequency	Percent	Cumulative Percent
Greatly effective	14	46.7	46.7
Somewhat effective	13	43.3	90.0
Ineffective	3	10.0	100.0
Total	30	100.0	

Table 7 : Corporate Governance And Increase In Investors' Faith			
	Frequency	Percent	Cumulative Percent
Some extent	14	46.7	46.7
Large	13	43.3	90.0
Not at all	3	10.0	100.0
Total	30	100.0	

Table 8(a) : Most Desirable Characteristic Of Board Of Directors				
Factor	No. of respondents			Total
	Rank 1	Rank 2	Rank 3	
Skilled and effective BOD.	18	6	6	30
Majority independent directors.	7	14	9	30
Separate managing director and chairman.	5	10	15	30

Table 8 (b) : Garrett Rank Test			
Factor	Total Score	Mean Score	Rank
Skilled and effective BOD.	1728	57.6	I
Majority independent directors.	1462	48.73	II
Separate managing director and chairman.	1310	43.67	III

Table 9(a) : Characteristics For Good Corporate Governance And Decision Making						
Factor	No. of Respondents					Total
	Rank 1	Rank 2	Rank 3	Rank 4	Rank 5	
Maintain integrity of accounts.	12	11	5	2	0	30
Ethical Behaviour.	6	7	7	6	4	30
Follow sound risk mgt. practices.	4	4	6	10	6	30
Protect minority shareholders' interest.	4	3	1	8	14	30
Maximize shareholders' value.	4	5	11	4	6	30

Table 9 (b) : Garrett Rank Test			
Factor	Total Score	Mean Score	Rank
Maintain integrity of accounting statements.	1985	66.16	I
Ethical Behaviour.	1611	53.70	II
Follow sound risk mgt. Practices.	1422	47.40	IV
Protect minority shareholders' interest.	1231	41.03	V
Maximize shareholders' value.	1493	49.76	III

DISCUSSION

The Table 1 indicates that 47 % of the respondents gave corporate governance the same importance as was given to financial growth numbers while investing. This reflects that corporate governance is taken into consideration by brokerage firms while investing.

Table 2 shows that 96% of the respondents invested in companies sometimes if the financial numbers of the same were attractive. Only 3% felt that they would never invest in companies with poor quality of corporate governance, even if they were financially attractive.

Table 3 indicates that 43% of the respondents were ready to pay a higher premium if the company displayed good corporate governance. This again reflects the importance attached to corporate governance while investing. The respondents were ready to pay a premium in the band of 10-20%. According to Table 4, 8% of the respondents could not quantify the amount of the premium they had to pay. The Table 5 examines the linkage between performance and governance. 63% of the respondents felt there was a moderate linkage between corporate performance and corporate governance. There was not a single respondent who felt that there was no linkage. This shows the importance of corporate governance from the view point of brokerage firms.

Table 6 finds out whether the Audit Committee played an important role in preventing frauds. 47% of the respondents were of the view that an audit committee will be more effective in preventing frauds. This shows the importance attached to the role of an audit committee in preventing fraud.

As per Table 7, 47% of the respondents felt that if there is an emphasis on corporate governance, it will result in an increase in investors' faith in the capital markets. This shows that regulators should tighten the rules for implementation of corporate governance and bring back the investors to the markets.

Table 8 shows that majority of the brokerage firms ranked skilled and effective BOD as the most desirable characteristic, followed by majority of Independent Directors, and separate Managing Director and Chairman was ranked third.

Table 9 reveals that brokerage firms rank maintaining integrity of accounting statements as the most important characteristic for corporate governance, fewer possibilities of frauds (ethical behaviour) as second, maximizing shareholders value was given the third rank, followed by sound risk management practices (4th rank), and protecting minority shareholders' interest as the fifth.

SUGGESTIONS

✿ Firms can improve investors' wealth by increasing disclosures, selecting well-functioning and independent boards, and imposing disciplinary mechanisms.

✿ Many Indian companies retain their auditors for years, which results in '*collusion*' between promoters and auditors.

✿ The demand for auditor's rotation is gaining ground after the Satyam Scandal. Companies should change auditors periodically. It is the role of the market regulator, Securities Exchange Board of India (SEBI), to educate and protect the investors. SEBI should tighten conditions for the appointment of Independent Directors, including divesting promoters from such decisions and increasing penalty for such white-collar crimes.

✿ India should have an independent regulatory body on the lines of Public Company Accounting Oversight Board (PCAOB) in the US to watch over the work of the auditors.

✿ More powers should be given to Frauds Investigation Officers to expedite investigation and set daunting deterrents for corporate frauds. Accountability should be fixed for all stakeholders.

✿ There should be prompt redressal of cases and grievances to build trust among investors.

✿ The investors' forum should play an active role in educating the investors. They should prompt the investors to play a more proactive role as stakeholders of the company and should constantly make the companies accountable for their stake.

CONCLUSION

Investors are very important stakeholders. They are crucial players in order to translate better corporate governance practices into better access to capital for firms. Sound corporate governance ensures that the interests of all stakeholders, including depositors are protected. Corporate governance cannot be regulatory. It is an instrument of

business and social transformation.

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