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Does Corporate Governance Affect Firm Performance? Empirical Evidence Based on the BSE 200 Index

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Abstract: Considering the endogeneity problem, this study investigates the impact of corporate governance attributes (CG) on firm performance in the Indian context. The sample of the study includes 174 companies listed on the Bombay Stock Exchange and the study period is eight years (2011–12 to 2018–19). This study is based on secondary data obtained from published annual reports (for CG data) and the Capitalineplus database (for accounting data). Based on the regression models (i.e., Ordinary Least Squares model and Two Stage Least Square model), the study shows that almost all CG attributes such as board size, gender diversity, CEO duality, and board independence are significantly associated with firm performance. We also find that the control variables such as firm size, debt, and R&D spending are also significantly associated with firm performance. This study is the first of its kind to focus exclusively on the attributes of market capitalization and corporate governance in an emerging market like India. These new insights into this relationship provide useful information to the government, academics, policymakers, and other stakeholders.

Keywords: capitalineplus database, corporate governance, firm performance, market capitalization, panel data.

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INTRODUCTION

Decisions on corporate governance (CG) efficacy began with Jensen and Meckling's seminal research (1976), which focused on the principal-agent problem. They argued that the principal-agent conflict arises from the separation of ownership from management in the corporate structure. In other words, if the agent (manager) carries out operations based on the interests and not the business owner's interests, the principal-agent conflict develops. Consequently, many previous business scandals, such as Satyam, Enron, WorldCom, Lehman Brothers, and AIG, took place. These incidents had a catastrophic impact on the confidence of financial market players and on the efficacy of CG procedures to promote accountability and transparency. This lack of confidence among stakeholders began to have a detrimental effect on the market value per share and, subsequently, on the company's total worth. Such corporate scandals made firms believe that company value relies on a proper

control system and not just on profits. The quality of monitoring systems may be accomplished via excellent CG, which guarantees effective management of companies and maximizes shareholders' value. The viability of any company depends on fostering openness and accountability in the modern knowledge-based economy and meeting the expectations of all stakeholders. CG is one of these instruments to accomplish this objective and protect different stakeholder groups' interests (Honggowati et al., 2017; Suteja et al., 2017).

On the one hand, globalization and liberalization in India made structural changes for the entire economy, and the function of CG in any company is a crucial factor. Further, the practice of CG has again become the most critical element for many Asian nations, including India, particularly following the 1997 financial crisis and previous company scandals (Zabri et al., 2016). Corporate managers have been concentrating on the CG problems of their businesses since the 1990s. The CG idea is thus not too old for India (Bhardwaj et al., 2014). In recent years, as Indian businesses expand globally, a more significant number of investors from industrialized nations have begun to demand strong CG standards.

Consequently, policymakers and regulators have made efforts to reform CG practices for Indian companies. For example, the SEBI has established CG rules and required Indian companies to adhere to the laws (Chauhan et al., 2016). These rules are intended to strengthen the CG of Indian companies, increase stakeholder confidence, and ultimately improve the company's performance. Trust amongst stakeholders implies building a good connection with stakeholders, and many academics see these relationships as the organization's wealth. Given that CG is vital in improving company performance (Ismail & Manaf, 2016; Terjesen et al., 2016; Abdullah, 2004; Alhussayen et al., 2020; Shin, 2021), many academics have researched whether CG can achieve tremendous business success. In other words, previous researchers examined different CG features, such as gender diversity, board composition, the duality role of CEOs, the size of the audit committee and independence of the audit committee to discover their effect on company performance. For instance, Uadiale (2010) investigated the relationship between CEO dualism and business success in Nigeria. Based on the OLS model, they discovered a strong positive link between CEO duality and corporate success in terms of returns of capital employees (ROCE). However, they showed a negative correlation between corporate success and Return on Equity (ROE). For 106 mid-size Indian companies, Kota & Tomar (2010) also investigated this relationship. They utilized Tobin's Q to evaluate company performance and discovered that the CEO duality had a substantial beneficial effect on firm performance. Guo & Kga (2012) found a positive association between CEO Duality and corporate performances in case of Colombo Stock Exchange. Similarly, based on the panel data model, Latif et al. (2013) have shown positive effects of the duality on ROA in the case of Pakistani listed sugar mills. In connection with 105 Nifty and Nifty Junior Companies, Varshney et al. (2013) examined this link between the two constructs. The results of the Pooled OLS and Random Effect Models show that CEO dualism relates to the economic value added (EVA) adversely. Their results match the effects of Dhamija et al. (2014) for 41 Nifty Index firms. However, when firm performance is evaluated using EPS, ROA, EVA, and Tobin's Q in Pakistan, Yaseer et al. (2014) have failed to show any substantial relationship between CEO dualism and company performance.

Ismail & Manaf (2016) linked gender diversity and company success assessed by average abnormal return in the context of Malaysian firms. Their research showed that gender diversity affects anomalous returns positively and significantly. The effect of a female director on corporate performance was examined by Terjesen et al. (2016) in 47 countries. The results of their multi-country research showed that women directors have a favorable influence on ROA and Tobin's Q company performance. In the context of 39 firms listed on the Mauritius stock market, Mahadeo et al. (2012) also obtained a similar finding. Again, Lückerath-Rovers (2013);

Debnath & Roy (2019) revealed a favorable effect of women directors on ROE and return on sales (ROS) for 99 Netherland and Indian companies, respectively. However, Ahern & Dittmar (2012) showed that gender diversity had a detrimental effect on the company performance of 248 publicly listed companies in Norway. Their findings were similar to the US and Norwegian companies' research conducted by Bøhren & Strøm (2010). In contrast, Rose et al. (2013) failed to detect any meaningful link between gender diversity and company performance. Likewise, Sanan (2016) and Solakoglu & Demir (2016) failed to demonstrate any impact on firm performance in India and Istanbul.

Researchers conducted numerous studies to investigate the influence of board size on a company's performance. Kathuria & Dash (1999) examined the effect of board size on corporate performance in 504 Indian companies. Their research showed that the board size significantly affects Indian companies' financial performance. Kiel & Nicholson (2003) found a favourable connection between board size and company performance assessed by Tobin's Q. Similarly, Pham et al. (2011) found the influence of board size on firm performance. Kiel & Nicholson (2003) also reviewed the effect on Australian corporate performance of the board size and found a favorable influence on corporate performance. Their finding was consistent with Setia-Atmaja (2008) for Australian firms, Jackling & Johl (2009) for Indian firms. However, Yermack (1996) found negative impact of board sizes on the market value of the US company. Similarly, Garg (2007) also found negative impact on firm performance in Indian context. In contrast, for 104 manufacturing companies from Australia, Bonn et al. (2004) found insignificant effects on firm performance measured by ROA. Likewise, Alshetwi (2017) has failed to articulate any significant effect on firm performance of 329 Saudi non-financial companies.

The independent directors play an essential part in monitoring the operation and general performance of the business and thus assist in reducing the difficulties of the organization. The business must thus select independent directors. Many empirical studies have been conducted to identify the link between the independence of the board and the success of companies. For instance, the association between board independence and company performance for 412 KLSE (The Kuala Lumpur Stock Exchange) firms was examined by Abdullah (2004). The research results showed a positive and substantial link between board independence and company performance using ROA, profit margin and income per share. Similarly for 277 Malaysian listed non-financial companies, Ameer et al. (2009) found a positive impact of independent directors on corporate performance. The research results are consistent with Veklenko (2016) results in the context of 79 European, Mohapatra (2016) in the context of Indian firm. However, Epps & Ismail (2009) reported negative impact on company performance in the US. Agrawal & Knoeber (1996) also found a negative relationship for 400 major United States companies. On the other hand, the relationships between the independence of the board of directors and the performance of Malaysia's businesses were insignificant for Rahman & Ali (2006). Alshetwi (2017) also identified an insignificant link between board independence and company performance for 329 Saudi non-financial companies.

These conflicting results show that there still exists some research gap. Hence, there is a need to revisit the relationship between CG attributes and firm performance. Therefore, the present study is a modest attempt to study the association between CG attributes and firm performance in India. To the best of our literature survey, we find that almost all of the prior literature, based on the Indian context, has been examined using accounting measures like ROI, EBIT, etc. No research is undertaken to evaluate CG's effect on corporate market capitalization in recent times. Most of the time, stakeholders, like investors, consider market measurements like market capitalization as an important criterion to understand the business's prospects. The aim of this research is thus to evaluate the effect of CG factors on market capitalization.

METHODS

This study consists of empirical research based on secondary data related to CG practices and firm performance. The first sample contained data from the top ranking 200 companies listed on BSE (Bombay Stock Exchange). Due to the many regulatory frameworks and reporting practices, the banking and financial sector companies are not considered. Public sector units (PSUs) are also not included in the research due to direct controls on reporting and performance-based rewards by the government. The final sample of the study thus consists of only 174 non-financial companies. Data on the CG attributes are collected from the CG report disclosed by the sample companies as per Clause 49 of the SEBI Act 1992. CapitalinePlus corporate database is used in this study to gather the financial data for eight years (i.e., from 2011- 12 to 2018-19).

Table 1 Definition of Variables

Name of the variable	Symbols	Definition of variables
Market Capitalisation	**MCAP**	Market price multiplied by the total number of outstanding shares for each month and then took average figure for regression analysis.
Board size	**BSIZE**	The total number of directors on the board.
Board Independence	**BODI**	The proportion of independent directors to the total number of directors in the board.
Gender Diversity	**GDIV**	The proportion of women directors to total number of directors in the board.
CEO-Duality	**CEOD**	Dummy value 1 if both the CEO and the chairman of the board have positions in a company, and 0 if otherwise.
Total sales	**SIZE**	Log value of the volume of annual turnover.
Leverage	**LEV**	Leverage is the debt-to-equity ratio.
Research & Development Expenditure	**R&D**	Log value of expenditure made of R&D during a particular year was considered.

Source: Author's tabulation.

Following recent research of Shawtari et al. (2016) and Widiatmoko et al. (2020), we use Market Capitalization (MCAP) as a proxy for evaluating firm performance. MCAP is derived by multiplying the market share price with the total share outstanding. Again, based on previous studies (Yermack, 1996; Beasley et al., 2000, Uadiale, 2010 and others), we also used CG attributes as the independent variable. These attributes are the board size, board independence, gender diversity, and CEO-duality. Further, company size, leverage and R&D spending are also considered control variables since prior research argues that company characteristics may influence financial performance (Debnath & Roy, 2017; Uwuigbe et al., 2015).

The regression equation adapted in the present study is modeled in the following form:

$$MCAP = \beta_0 + \beta_1[BSIZE] + \beta_2[BODI] + \beta_3[GDIV] + \beta_4[CEOD] + \beta_5[SIZE] + \beta_6[LEV] + \beta_7[R\&D] + \mu it \ldots (i)$$

Where,

μ = error term.

β_0= intercept of the equation. β_1 to β_7 = coefficients.

'i' and 't' = subscripts for entity and time period, respectively.

RESULTS AND DISCUSSION

Descriptive statistics is a technique for summarizing the data set, and Table 2 shows all variables of the current research. Table 2 indicates that the mean value of market capitalization is 7.960 and the minimum and maximum values are 1.900 and 13.900, respectively. The standard deviation is found to be only 2.033. The Table also reveals that the company's average board of directors is around 10 directors with variations from 2 to 21 members of directors. Likewise, the number of female board directors ranges from 0 to 5, with an average of 1 (approx.) director(s) indicating that some firms where no female director(s) were recruited to introduce gender diversity into the board. The Table also noted that about 42% of the sample companies have CEO duality positions in the board. Board independence indicates that around 52.88% of the board's directors are independent, with broad independence ranging from 17% to 100%.

Further, the mean value of the firm size is 7.840 and its minimum and maximum values range from negative 1 to positive 12. The standard deviation of firm size is 1.63. The leverage ratio of selected sample firms appears to be 1.013. There has been a considerable variation in R&D expenditure among the firms under consideration as depicted by maximum and minimum value accompanied by a high value of standard deviation as compared to its mean value.

Table 2 Descriptive Analysis

	BSIZE	BODI	GDIV	CEOD	MCAP	SIZE	LEV	R&D
Minimum	2.000	17.000	0.000	0.000	1.900	-1.000	-1.140	-5.000
Maximum	21.000	100.000	5.000	1.000	13.900	12.000	9.760	8.000
Mean	9.710	52.880	0.950	0.420	7.960	7.840	1.013	1.560
Std. Dev.	2.737	9.657	0.758	0.493	2.033	1.637	1.334	2.235
Note: The number of observations (N) is 1392.								

Source: Authors Calculation

Table 3 Correlation Matrix

	MCAP	BSIZE	BODI	GDIV	CEOD	SIZE	LEV	R&D
MCAP	1							
BSIZE	0.329**	1						
BODI	0.132**	0.026	1					
GDIV	0.341**	0.250**	0.024	1				
CEOD	0.187**	0.04	0.158**	-0.002	1			
SIZE	0.441**	0.257**	0.161**	0.105**	0.085**	1		
LEV	-0.317**	-0.011	-0.015	-0.122**	-0.046	0.018	1	
R&D	0.608**	0.221**	0.173**	0.110**	0.122**	0.436**	-0.210**	1
Note: ** and * indicate correlation is significant at the 0.01 and 0.05 levels (2-tailed),respectively.								

Source: Authors' calculation

The Pearson correlation matrix of the variables under investigation is shown in Table 3. The findings show that none of the variables has a high degree of correlation. The highest coefficient of correlation between market capitalization and R&D spending is 0.608 and it is not very high. All other factors are linked with lower correlation scores. This finding indicates that there is no multi-linearity issue in the current data set. This finding has been further confirmed by the VIF test as given in panel (a) of Table 4, which shows VIF values for all variables are below five, which is less than the threshold limit, i.e., 10. The statistical value of Durbin Watson (0.893) further shows that there is no serial correlation in the present data set.

The regression result is obtained using an Ordinary Least Squares (OLS) regression model. As shown in Table 4, the findings are based on market capitalization as the dependent variable, CG characteristics as the independent variable, and a few firm-specific features as the control variable. In Table 4, panel (a), the F-statistic value is 21.60, which is significant at the 1% level, indicating that the hypothesis of a significant linear relationship between the performance and explanatory factors cannot be rejected. R-square and adjusted R-square values also indicated the same.

The regression analysis in Table 4 examines the effect of the CG mechanism on firm performance. The empirical analysis demonstrates a strong positive relationship between board size and company performance as measured by market capitalization, indicating that board size improves firm profitability throughout the study period for the sample companies in India. This result is similar to Dalton et al. (1998), who discovered that board size had a favorable effect on company performance. Previous studies noted that a large board could employ a diverse pool of competent directors to monitor and evaluate management activities that improve performance (Debnath, 2018; Dalton et al., 1998). However, Gugnani (2013) and Arora & Sharma (2016) demonstrated that board size is negatively linked with company performance and urged big boards to spend time in arriving at any consensus and decision making. Additionally, the big board has coordination challenges due to social loafing (Lipton & Larsch, 1992), eroding its monitoring effectiveness and making it incapable of holding management responsible. However, Hamdan et al. (2013) discovered no correlation between board size and market capitalization. Again, board independence adversely affects market capitalization, which contradicts Debnath's results (2018). The plausible reason may be that India's CG mechanism is not as effective as other nations, and it serves as more of a facade and illusion than a reality. Second, independent directors who are also directors of many other businesses may be overburdened and unable to fulfil their assigned duties. CEO-duality occurs when the CEO of a business also serves as the chairman of the board of directors. The regression analysis in this research shows that CEO duality has a negative effect on company market capitalization, which is consistent with the theoretical assumption that when the CEO simultaneously serves as chairman, he conceals his inefficiency by holding the highest position.

In panel (a) Table 4, regression analysis further reveals a favorable association between gender diversity and market capitalization, which indicates that adding female members to the board of directors promotes market value. This positive association is statistically significant at the 5% level. The outcome corroborates Debnath & Roy's (2019) findings that the presence of women directors provides direct oversight of their management to align their interests with those of shareholders. Additionally, the effectiveness of monitoring management activities tends to result in the disclosure of higher-quality information and the reduction of agency issues related to ownership separation. Thus, all the alternative hypotheses are accepted based on the regression findings.

Additionally, the regression table shows that company size positively affects market capitalization. This finding implies that companies with a higher yearly revenue generate a more significant market capitalization

and vice versa. According to previous research, big companies benefit from economies of scale and a substantial market share; as a result, they perform better than smaller enterprises. Another firm-specific variable, leverage, as measured by the debt-to-equity ratio, has a substantial adverse effect on market capitalization. This conclusion is consistent with the findings of Shawtari et al. (2016). They stated that better-performing firms could reinvest profits and are hesitant to take on debt financing. Debt financing is particularly discouraging due to the fundamental features of debt capital, which carries fixed obligations regardless of the firms' level of profit. Further, Research and Development (R&D) is the most crucial component of a business's activities, with substantial money spent on product invention and development and market research for growth. As a result, this spending is anticipated to have a progressive effect on company valuations. The regression result also shows the same thing.

Again, we have further attempted to evaluate the effect of CG characteristics on accounting-based metrics of firm performance, such as return on capital employed (defined as profit after tax divided by capital employed) and return on assets (measured by dividing profit after tax by total assets). Results are shown in panels (b) and (c), respectively. The findings show that most CG factors are insignificant, except gender diversity which is significant in all panels. We also find that the impact of board size is positive and significant in panel (b) and negative significant in panel (c).

Table 4 Ordinary Least Square Regression analysis

Panel A: Dependent Variable: Market Capitalisation								
Variables	Const.	BSIZE	BODI	GDIV	CEOD	LEV	R&D	SIZE
Coeffi.	23.286	0.683	–1.223	0.826	–1.548	–0.564	0.563	2.48
Std. Error	2.012	0.199	0.325	0.395	0.592	0.218	0.144	0.237
t-ratio	11.570***	3.420***	–3.750**	2.09**	–2.610***	–2.580**	3.890***	10.450***
VIF	-	3.81	4.029	1.086	1.07	2.722	2.986	1.245
Note: R-squared = 0.0985; Durbin-Watson = 0.893; F-statistic = 21.60 (0.000); Adj. R-squared = 0.0939; N = 1392								
Panel B: Dependent Variable: Return on Capital Employed								
Coeffi.	47.996	-3.46	2.645	19.353	6.249	0.497	3.375	-2.876
Std. Error	21.77	2.547	4.166	5.014	7.578	2.793	1.935	2.519
t-ratio	2.200**	-1.36	0.64	3.86***	0.82	0.18	1.74*	-1.14
Note: R-squared = 0.187; Durbin-Watson = 0.623; F-statistic = 3.63 (0.000); Adj. R-squared = 0.181; N = 1392								
Panel C: Dependent Variable: Return on Assets								
Coeffi.	-0.095	-0.003	0.008	0.025	0.008	-0.003	0.013	0.012
Std. Error	0.035	0.004	0.006	0.008	0.012	0.004	0.003	0.004
t-ratio	-2.71***	-0.78	1.24	3.17***	0.71	-0.82	4.39***	3.18***
Note: R-squared = 0.0967; Durbin-Watson = 0.773; F-statistic = 10.02 (0.000); Adj. R-squared = 0.0943; N = 1392; ***, **, and *Significance at 1, 5, and 10%, respectively.								

Source: Authors' calculation.

It is also important to note that endogenous variables exaggerate regression outcomes and in the present study, the CG variables are considered endogenous in nature. Therefore, to find whether the regression results shown in Table 4 are affected by endogenous variables or not, we have carried out instrumental variables (Two-Stage Least Square) regression model which also serve the purpose of robustness check. The results are shown in Table 5. The outcomes of the regression results are the same as those shown in table 4. We have carried out Durbin (Score) Chi-square and Wu-Hausman test to check the endogeneity issue in our model. In this test, null hypothesis (H0): variables are exogenous. The outcome of these tests shown in table 5 is not significant, indicating that the endogeneity is not an issue for the current data set. Hence null hypothesis is accepted. Moreover, Shea's Partial R-squared values in Table 5 indicate that the model is well accepted. Therefore, both the regression results shown in Table 4 and 5 are reliable and robust.

Table 5 Instrumental variables (2SLS) regression

Variables	Coefficient	Std. Error	t-ratio	
Const.	23.110	2.232	10.35***	
BSIZE	0.970	0.302	3.200***	
BODI	–1.696	0.523	–3.240***	
GDIV	0.984	0.578	1.700*	R-squared = 0.089; Wald Chi-squared = 118.01***
CEOD	–1.709	0.725	–2.360*	
LEV	0.533	0.232	2.300**	
R&D	0.556	0.157	3.530***	
SIZE	2.422	0.261	9.250***	
Note: MC is dependent Variable **Test of Endogeneity:** ***Durbin (Score) Chi-square*** = 2.26074 (p = 0.687) ***Wu-Hausman F(4,1206)*** = 0.560 (p = 0.691)				
Shea's Partial R-squared:				
Variable	**Partial R-sq**	**Adj. Partial R-sq**		
BSIZE	0.5292	0.5261		
BODI	0.4781	0.4747		
GDIV	0.5733	0.5705		
CEOD	0.7882	0.7868		
Note: ***, **, and *Significance at 1, 5, and 10%, respectively				

Source: Authors' calculation.

According to the IMF's latest report (2019), India is the fastest-growing economy. As a result, India is a desirable investment destination, and CG can play a critical role in fostering stakeholder trust in making investment choices. According to Das (2014), a robust CG system contributes significantly to stakeholders' trust in making investment choices. The outcomes of the current study indicate that a more effective CG mechanism results in a higher market value for a firm. This result may persuade overseas investors to invest. The findings

may also inspire firms to develop and maintain sound CG practices. Such practices will aid in the development of competitive advantages that enhance the firm's overall performance. The current research adds to the academic literature by demonstrating that establishing an effective CG mechanism may benefit companies. Additionally, the findings of this research have consequences for policy makers and regulators in creating better CG rules, which will aid investors from both international and domestic nations in making investment choices that will boost economic growth.

CONCLUSION

Ideally, the CG system is designed for the board of directors to achieve a range of business goals and give them appropriate incentives to achieve these goals. Effective CG enables an effective monitoring process to assist firms in using their resources carefully to prevent abuse, theft, and other illegal management choices, leading to information asymmetry between insiders and outsiders. The interests of the different parties may thus be achieved with a legal and appropriate framework that can undoubtedly contribute to the economic well-being of all stakeholders. It is thus the essence of any corporation and must be adhered to when doing business. It plays a crucial role in protecting the valuation of a company because the ultimate goal of a suitable governance mechanism is to maximize the interest of all stakeholders. In an attempt to study the impact of CG attributes on firm performance, we empirically found that the CG attributes have a positive effect on firm performance, which is consistent with the earlier results. The outcomes of the study indicate that CG can play a critical role in positively affecting the firm performance measured by market capitalization, in India. Consequently, such a positive impact on the share price will attract investors from domestic and foreign markets. Such investments from the foreign market will boost the host country's economy. We also found that firm-specific factors such as size, leverage, and R&D spending also significantly influence the firm's market capitalization. Furthermore, the current research is not free from limitations. For example, the current study is based on the Indian context and thus, we suggest that future studies must consider the cross-country dataset to get a clear picture of the impact of CG on firm performance. The future study may also consider a larger study period. Future research may also rely on ownership patterns, the type of independent statutory audit firms, financial literacy of independent directors, and multiple directorships as CG factors that are not addressed in this study.

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