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Corporate Governance in India: Clause 49 of the Listing Agreement

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ABSTRACT

In the wake of the biggest financial scandal (the Satyam scam case) in India and in the context of the global financial crisis, the term corporate governance (CG) has become a topic of hot debate. CG has been gaining momentum across the world due to unethical business practices and insufficient disclosures. Inequality, glorification of greed, lack of concern for society, feudal mindset and manifold regulations are some reasons responsible for increase in the rate of scams. The issue is particularly important for developing country like India since it is central to financial and economic development.
India has one of the best CG laws but poor implementation together with socialistic policies of the pre-reform era has affected CG. Concentrated ownership of shares, pyramiding and tunneling of funds among group companies mark the Indian corporate landscape. Since liberalization, however, serious efforts have been made at overhauling the system with the Securities & Exchange Board of India (SEBI) instituting the Clause 49 of the Listing Agreements dealing with corporate governance.
In India, it is mandatory for all the listed companies to comply with the revised Clause 49 of listing agreement, which came into operation on January 1, 2006 to protect the interests of investors through enhanced governance practices. This study seeks to determine the extent to which Indian listed companies disclose their CG practices by examining the annual reports of 50 listed companies. Also, the determinants of disclosures have been looked into. The paper concludes that there is a substantial scope for improvement in the CG disclosure practices and the size of the company is a significant determinant of disclosures.
Keywords: Corporate Governance, Clause 49, SEBI, Listed Companies.

1. INTRODUCTION

India has one of the best CG laws but poor implementation together with socialistic policies of the pre- reform era has affected CG. Concentrated ownership of shares, pyramiding and tunneling of funds among group companies mark the Indian corporate landscape. Since liberalization, however, serious efforts have been made at overhauling the system with the SEBI instituting the Clause 49 of the Listing Agreements dealing with CG.

The principal characteristic of effective CG is transparency which is reflected in the disclosures made by the firm. Disclosures play an important role in ensuring transparency. Transparency means adequate and timely dissemination of information by a company of its operations to its stakeholders. The company on its own should come out with adequate and timely disclosures of actual happening and honest anticipation of material events that affects the value of the company.

2. LITERATURE REVIEW

[1] studied the CG reporting practices of 30 listed companies in Bombay Stock Exchange (BSE), Sensex by extracting CG section from the annual reports. According to [1], although the companies provided information related to all dimensions there was considerable variance in the extent and quality of disclosure made by the companies in the annual reports.

[2] examined a sample of 50 US firms and their public disclosure packages from 2004. [2] found that smaller firms provided fewer disclosures pertaining to board selection procedure, oversight of management and independence as compared to larger firms who provided more disclosures relating to audit committee matters, board selection procedure, independence standards and whistle-blowing procedure. [2] also found that boards that were of lesser independence provided less information relating to management oversight and independence matters.

[3] analysed the extent to which Australian companies disclose their CG practices by examining the annual reports of 268 listed companies. [3] used content analysis method for the study. [3] found that the extent and quality of disclosure is typically better for larger companies as compared to small companies.

[4] examined the effectiveness of 'comply or explain' with respect to CG in the U.K. For the study, [4] used database of non-financial companies. [4] made a detailed analysis of both the degree of compliance with the provisions of CG code of best practices as well as explanations given in case of non-compliance. The study revealed an increase in the trend for compliance as well as use of uninformative explanations in case of non-compliance.

[5] analysed as to whether difference in the quality of firm-level CG has an effect on the firm-level performance of the companies listed in the Karachi Stock Exchange. [5] used Tobin's Q and total CG Index (*CGI*) for the study. [5] analysed 50 firms for the study. [5] found that ownership, shareholding and board composition enhanced firm performance while transparency and disclosure have no significant effect on firm performance.

The literature review reveals that relatively less attention has been paid to the concept of CG in India as compared to the rest of the world and this created the need for this study.

3. HYPOTHESIS

The following hypothesis were formed and tested with respect to this study:

(a) Hypothesis 1 : *Better profitability of company results in better disclosures on CG.*

(b) Hypothesis 2 : *Market performance of firm has a significant positive relationship with CG disclosures.*

(c) Hypothesis 3: *Size of the company is positively associated with extent of CG disclosers by the company.*

4. METHODOLOGY

A total of 50 companies were selected for the study. Any company with its registered office in eastern India constituted the sample. Companies included in the sample belonged to various industry groups and sectors [Appendix II]. A majority of the companies belonged to tea (28%), leather (24%) and jute (16%) industry.

CG disclosure practices in this study were examined from the annual reports of companies selected [6]. A list of **67 parameters** [based on the list of items suggested by SEBI in Clause 49 of the listing agreement] and other non-mandatory items needed to be disclosed in the CG section in the annual report was prepared. The annual report was analysed using content analysis technique.
Annual reports of the companies were analysed for the presence of **nine broad dimensions** as suggested by SEBI. Also, **67 statements** [Appendix I] related to each of these dimensions, Management Discussion and Analysis (MDA) and miscellaneous category were drawn as a framework to calculate disclosure score in order to understand the disclosures of these dimensions in the annual report.

A dichotomous procedure was followed to score each of the disclosure items. Each company was awarded a score of '1' if the company disclosed the concerned issue and '0' otherwise. The net score of each company was found by adding all the individual scores of various sub-dimensions. The maximum score that a company could obtain was **67** i.e. if all the items were disclosed. Every item was given **equal weight** because each item was considered equally important. The **67 statements** included both mandatory and non- mandatory stipulations of the regulation.

CG Disclosure Index (*CGDI*) was formed using the following formula [6].

$$CGDI = \frac{Total\ Score\ of\ the\ Individual\ Company}{Maximum\ Possible\ Score\ Obtainable\ By\ The\ Company} * 100$$

The value of *CGDI* ranged between '0' and '100' with '0' reflecting the worst disclosure and '100' representing the best disclosure practices. It should be noted that CGDI indicates only the presence of information about a particular item in the annual report and not about the quality or extent of disclosure of a particular item.

The following regression equation was formulated for this study:

$$CGDI = \beta_1 + LnVA + \beta_2\, ROE + \beta_3\, MBV + \beta_4\, PI + \beta_5\, INDUM + et$$

DEPENDENT VARIABLE: CGDI

INDEPENDENT VARIABLES:

(a) PERFORMANCE:

(i) Market to Book Value (*MBV*): Market Value of Common Stock divided by Book Value of Common Stock.

[MBV ratio was calculated to judge the market performance of the firms.]

(ii) *Tobin's Q:* *Tobin's Q* was calculated as (*BV* of preference stock + *BV* of borrowings + *BV* of *CL* + *MV* of common stock) / *BV* of total assets denoted by *FA* + *INV* + *CA*) with all values computed at the end of the year.

[*Tobin's Q* was used as the proxy for the performance]

(b) PROFITABILITY:

(i) Return on Assets *(ROA)*: Computed as Profit After Taxes (*PAT)* / Total Assets.

(ii) Return on Equity (*ROE*): Computed as PAT / Net Worth.
[ROA and ROE had been used as alternative measures of profitability in this study.]

(c) SIZE:

(i) Market Capitalisation (*LnMC)*: Natural Log of Market Value of Common Stock in lakhs.

(ii) Book Value of Assets (*LnBVA*): Natural Log of Book Value of Assets in lakhs.

[*LnBVA* was used as the proxy for the size of the company.]

(d) CONTROL VARIABLES:

(i) Proportion of Independent Non-Executive Directors (*PI*): Percentage of Independent Directors on the board.

{A greater proportion of Independent Directors bring about more financial disclosures [7].}

(ii) Debt- Equity Ratio (*DE*): Computed as Total Debt / Net Worth.

(iii) Index Dummy (*INDUM*): '1' if the firm is included in NSE/BSE index i.e. Nifty/ Sensex, otherwise '0'.

[It is a dichotomous variable with a value of '1' if the firm is listed in NSE/BSE and '0' otherwise. It is generally considered that companies which forms part of a security index will disclose more information on CG.]

5. RESULTS

Table 1: Frequency Distribution of CGDI

FREQUENCY DISTRIBUTION OF CGDI				
Total Score (%)	**Frequency (N)**	**Cumulative (N)**	**Percentage (%)**	**Cumulative (%)**
Above 90	**5**	5	10.0	10.0
81-90	**21**	26	42.0	52.0
71-80	**11**	37	22.0	74.0
61-70	**8**	45	16.0	90.0
51-60	**2**	47	4.0	94.0
Below 50	**3**	50	6.0	100.0
Total	**50**	-	100.0	-

(a) From Table 1 it can be seen that 5 companies received a score of above 90%, 21 companies have a score between 80-90% , 11 companies have a score between 70-80%, 8 companies have a value between 61-70%, 2 companies have a value between 51-60% and 3 companies have received a value of below 50%. It can be concluded from the above analysis that disclosure practices in the sampled companies are reasonable and few companies have a lower value.

(b) ITEM –WISE DISCLOSURE OF CORPORATE GOVERNANCE:

The item-wise disclosure [Appendix I] reveals that mandatory as well as non-mandatory disclosures have not been disclosed by all the companies. Only 9 out of the total mandatory items [which forms a majority of the items in Appendix I] have been disclosed by 100% companies. 14 items are disclosed by more than 90% of the companies, 8 items are disclosed by more than 80% of the companies and 16 items are disclosed by less than 50% of the companies.

(c) DETREMINANTS OF DISCLOSURES:

From the analyses it can be inferred that the extent of disclosures varies among companies. Studies indicate that the extent of disclosure on CG calculated in terms of *CGDI* is influenced by various factors. According to [1], there are three determinants of CG disclosure namely size of the company, overseas listing status and number of independent directors. [8] found financial disclosures to be related to earnings margin, size and listing status. Furthermore, [6] found local ownership, Securities and Exchange Commission notification amd size to be the significant factors of CG disclosures.

(d) REGRESSION RESULTS:

Table 2: Regression of CGDI on Other Variables

Regression of CGDI on Other Variables		
	CGDI	
	(1)	(2)
Intercept	34.686*** (3.060)	36.881*** (3.346)
Ln*BVA*	9.216*** (3.785)	**8.058*** (3.326)**
MBV	-	**1.297** (2.061)**
ROE	-	0.120 (0.824)
PI	-	0.085 (0.682)
DE	-	- 0.036 (-0.290)
INDUM	-	- 0.315 (-1.816)
R^2	**0.230**	**0.294**
Adjusted R^2	**0.214**	**0.264**
F- Stat.	**14.328*** **	**9.774*** **
Durbin-Watson	-	2.102
VIF	**1.000**	**1.057**

Note: Table 2 represents the regression model with *CGDI* as the dependent variable and other variables are the independent variables. t-statistics are reported in parentheses. ** and*** indicate significance levels at 5% and 1% levels.

From Table 2 it can be seen that in Model 1, *LnBVA* explains 23% variance in *CGDI*, as shown by R^2. This increases to 29.4% when *MBV* enters the equation in Model 2. Adjusted R^2 is 0.214 for Model 1 and 0.264 for Model 2. In Model 1, the *F-ratio* is 14.328 and is highly significant at less than 1% level of significance and in Model 2 it becomes 9.774 which is also significant at less than 1 % level of significance. The Variance Inflation Factor (*VIF)* is used to assess multicollinearity. The *VIF* lies between 1.0 and1.057. Threshold levels of tolerance (not shown in the above table) of above 0.10 and *VIF* scores of less than 10 suggest minimal multicollinearity and stability of the parameter estimates.

From Table 2 it can be inferred that Ln*BVA* (b = 8.058, t-statistic = 3.326 and $p < 0.01$) is positively contributing towards disclosures. The only significant control variable is *MBV* (b = 1.297, t- statistic = 2.061 & $p < 0.05$) while all other control variables have been excluded as these do not have a significant positive or negative coefficient indicating that these variables do not influence *CGDI* (dependent variable). It should be noted that *DE* and *INDUM* have negative coefficients.

Table 3: Regression of CGDI on Other Variables

Regression of CGDI on Other Variables		
	CGDI	
	(1)	(2)
Intercept	34.686*** (3.060)	36.881*** (3.346)
Ln*BVA*	9.216*** (3.785)	8.058*** (3.326)
MBV	-	1.297** (2.061)
ROA	-	- 0.181 (-0.525)
PI	-	0.085 (0.682)
DE	-	- 0.036 (-0.290)
INDUM	-	- 0.315 (-1.816)
R^2	0.230	0.294
Adjusted R^2	0.214	0.264
F- Stat.	14.328***	9.774***
Durbin-Watson	-	2.102
VIF	1.000	1.057

Note: Table 3 represents the regression model with *CGDI* as the dependent variable and other variables are the independent variables. t-statistics are reported in parentheses.** and*** indicate significance levels at 5% & 1% levels.

Alternative proxies of performance, profitability and size were used to check the robustness of results .*MBV* was replaced by *Tobin's Q*, *ROE* was replaced by *ROA* and *LnBVA* was replaced by *LnMC* as independent variables. It can be seen that when *Tobin's Q* replaced *MBV* the only variable that explained the variation in *CGDI* was size i.e. *LnMC* and *LnBVA* . In addirion, all the results remained the same when *ROE* was used instead of *ROA*. Both performance (*MBV*) and size (*LnBVA*) explained the variation in *CGDI*. Furthermore, when *LnBVA* was replaced by *LnMC* the only significant variable that explained the variation in *CGDI* was size i.e. *LnMC.*

From the regression analysis it can be concluded that profitability is not significantly related to disclosure of CG practices even when *ROE* or *ROA* is used. It can be seen that firm performance to an extent is positively related to disclosure but it does not sustain the robustness check while size of company is found to be positively and significantly related to disclosure of CG practices. Hence, we ***accept Hypothesis 3*** and ***reject Hypothesis 1 and 2***.

6. CONCLUSION

The study generated the following conclusions:

(a) The size of the company is a significant determinant of disclosure. The extent and the amount of disclosure is better in larger companies as compared to the smaller ones. One reason may be that large firms have to disclose more information related to CG practices since they get a lot of attention from the investors [9].

(b) There is a considerable gap in the quality and quantum of disclosures made by companies in the annual report. Not only the non-mandatory but also many mandatory requirements have not been disclosed by the companies.

(c) There is substantial scope for improvement in the CG disclosure practices. Many companies did not disclose a number of important issues. The compliance level with respect to remuneration committee, board of directors, statement of philosophy, general body meetings, general shareholder information and miscellaneous is high where as with respect to shareholder committee, audit committee, MDA and means of communication is not very high.

Finally, it should be noted that although SEBI had issued various guidelines for improving CG norms in India, the onus to follow the same lies with the companies to compete in the global economy.

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