

Non-mandatory Recommendations under the Corporate Governance Code and Investor Protection: An Evaluation

Arwah Madan¹⁺, Jayashree Upadhye² and Arjun Madan³

¹St. Mira's College for Girls, (Affiliated to University of Pune), Pune, Maharashtra, India

²Dept. of Economics, Abeda Inamdar Senior College of Arts, Science and Commerce, (Affiliated to University of Pune), Pune. Maharashtra, India

³Research Centre in Economics, Ramkrishna More Arts, Commere and Science College (Affiliated to University of Pune), Pune. Maharashtra, India

Abstract. Much empirical research is now available on the adoption and impact of corporate governance code in India. The existing research studies have been carried out in the period immediately following the adoption of the code of corporate governance in India. Hence, these studies are unanimous on the fact that corporate governance is in a very nascent stage; and that it is too early to analyze and assess its impact. Secondly, most of the research work is carried out taking into consideration the large companies. This may be partly due to the recommendations by earlier committees requiring phased implementation of the corporate governance code.

This paper makes an attempt to look at the adoption of the code of corporate governance by the mid-cap companies in India; and more importantly the adoption of the non-mandatory recommendations in these companies. The study concludes that there is a fair adoption of the code of corporate governance among the mid-cap companies in India. The adoption of the non-mandatory measures in addition to the mandatory measures is found to influence firm performance. At the same time, there is a difference observed in the firm performance of companies meeting mandatory requirements and companies meeting mandatory requirements as well as adopting non-mandatory requirements. These findings are in the shareholders interest and in favour of investor protection. The use of the postal ballot and the adoption of the whistle blower policy indicate the changing attitude of the Indian corporate sector.

Keywords: Corporate Governance Code, Mid-cap companies, Non-mandatory recommendations, Investor Protection.

1. Introduction

Research on corporate governance in India is been gaining much importance and attention. Much empirical research is now available on the adoption and impact of the implementation of the corporate governance code in India. The existing research studies have been carried out in the period immediately after the adoption of the code of corporate governance. Hence, these studies do admit to the fact that corporate governance is in a very nascent stage in India; and that it is too early to analyze and assess its impact. Secondly, most of the research work is carried out taking into consideration the large companies. This may be in the light that the early committees did outline who should implement the corporate governance code. This paper makes an attempt to look at the implementation of the code of corporate governance in the mid-cap companies in India; and more importantly the adoption and implementation of the non-mandatory recommendations in these companies.

1.1. Review of Literature

The efficacy and strength of corporate governance is closely related to the effectiveness of corporate law. Empirical research suggests that the level of shareholders protection is positively correlated with the

⁺ Corresponding author. Tel.: +(M)91 09420697784.
E-mail address: dr.arwahmadan@gmail.com.

development of stock markets as measured by standard indicators such as market capitalization and turnover ratio¹. The East Asian economies with more effective corporate laws were able to withstand the financial crisis of 1997-98 better than those in which shareholders were afforded fewer protections by the law on the books and the effectiveness of legal institutions². Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments. If these mechanisms did not exist or did not function properly, outside investors would not lend to firms or buy their equity securities. Businesses would be forced to rely entirely on their own internally generated cash flows and accumulated financial resources to finance ongoing operations as well as profitable investment opportunities. Overall economic performance likely would suffer because many good business opportunities would be missed and temporary financial problems at individual firms would spread quickly to other firms, employees, and consumers. From the vast literature on the relationship between economic growth and legal system emerged an important view that legal structures have a significant influence on economic development. The evidence suggesting that effective protection of the rights of investors and officials operating within a framework of known legal rules are conducive to stronger economic development.

1.2. Objectives and Methodology

Though the Confederation of Indian Industry was the first to take up the initiative on the issue of corporate governance, it was the report of the SEBI Committee on Corporate Governance (Kumar Mangalam Birla Committee, 1999) that changed the landscape of corporate governance in India, making it a statutory and mandatory requirement by adding Clause 49 to the Listing Agreement. This was later followed by the report on Corporate Audit and Governance (Naresh Chandra Committee, 2002) and the report of the SEBI Committee on Corporate Governance (N.R. Narayana Murthy Committee, 2003). The above committees made mandatory recommendations on the composition and size of board of directors, audit committees, remuneration committees, board procedures, management, shareholders and institutional shareholders, etc. Certain non-mandatory recommendations were also made by these committees. The implementation of the non-mandatory measures is a matter of choice.

1.2.1 Objectives

To make an assessment of the adoption of the code of corporate governance in the mid-cap companies.

To make an appraisal of the adoption and implementation of the non-mandatory recommendations along with the mandatory recommendations in the Corporate Governance Code.

1.2.2 Hypothesis

The adoption of non-mandatory measures along with mandatory measures does not influence firm performance.

There is a no difference in the firm performance of companies meeting mandatory requirements and companies meeting mandatory requirements as well as adopting non-mandatory requirements.

1.3. Data & Methodology

The technical definition of ‘mid-cap’ in the Indian context taken into consideration for this study is, “a company with a market capitalization between Rs.150 – Rs.500 crore”.

The Dalal Street Investment Journal’s annual compendium, “Mid-Cap 400” for the year 2008 was taken as a reference point. This is the data publication that lists the BEST 400 companies in the mid- cap segment; the companies are ranked based upon four universally accepted parameters, viz.: (1) Market Capitalization (2) Profit (3) Sales Turnover and (4) Dividend Declared. It is an annual publication.

A random selection was made taking into consideration the score (DS Score) given to companies in the Dalal Street Investment Journal. Twenty five percent of the companies were selected based on the DS ranking given to the 400 companies by the journal.

To analyze the performance of the companies, Tobin’s Q was calculated for a period of two financial years – 2007-2008 and 2008-2009. Data was collected from the annual reports from the companies’ websites.

1.4. Limitations of the Study

The research is limited to companies defined as ‘Mid-cap’ by the Dalal Street Investment Journal. The sample studied is not compared with the total population.

The calculation of firm value i.e. Tobin's q may be influenced by other factors such as market hype and intangible assets.

2. Observations and Findings

It was interesting to note that 60% of the sample has met the requirements under the clause 49 of Listing Agreement. The remaining companies either did not have (i) an operational website or did not have (ii) complete information disclosed or annual reports available on their website.

The average board size of the companies in the sample is observed to be 10.32 which is well above the recommendation under the Clause 49 of Listing Agreement, i.e.7 members, out of which 4 are to be independent directors. The average number of independent directors for the sample was observed to be 4.94.

It was observed that 42% of the sample did have a non-executive chairman; however, only 7% of the sample did mention that they have an independent non-executive chairman.

It is also observed that board meetings are held as per requirement, i.e. 4 meetings to be held in a year.

The Tobin’s Q scores for the two categories i.e. sample having adopted non-mandatory measures and sample not adopting non-mandatory measures are as follows:

TOBIN’S q	Sample adopting non-mandatory measures		Sample not adopting non-mandatory measures	
	2007-08	2008-09	2007-2008	2008-09
YEAR				
AVERAGE	5.34	3.72	1.66	1.72
MIN	0.22	0.29	0.38	0.27
MAX	17.04	7.72	6.34	7.91
STDEV	12.81	7.07	1.46	1.66
COEFFICIENT OF VARIATION	2.39	1.89	0.87	0.96

2.1. Hypothesis Testing

Most studies have also made these observations in their research findings that the mandatory requirements under Clause 49 of Listing Agreement are completely followed by companies. The findings of this study are also consistent with the other studies on the implementation of the code of corporate governance in India. The disclosures on board characteristics were considered; the result was found to be insignificant. As a result, there is no relation established between the disclosure norms and its impact on the level of investor protection. The findings of the present study are consistent with the findings of the study by Jayesh Kumar⁴ that firm performance and ownership concentration are not related. The findings are also consistent with the findings of the study by Berkman et al⁵ that there is a negative relation between firm performance and independence of directors.

The study takes into consideration the implementation of the non-mandatory measures along with the mandatory recommendation under the code of corporate governance. The adoption of the non-mandatory measures is a matter of choice. The study reviewed the acceptance and implementation of two non-mandatory measures- the use of postal ballot and the adoption of the whistle blower policy. In the above sample, it was observed that 24.28% of the sample has made use of the postal ballot to pass key resolutions while 20% of the sample has adopted the whistle blower policy in their company.

2.1.1 The first hypothesis aims at testing ‘the adoption of the non-mandatory measures along with mandatory measures does not influence firm performance.’

The disclosures made by the sampled companies on the adoption of the whistle blower policy were taken as additional parameter along with the disclosure norms on board characteristics. A chi-square test was computed to test whether all these disclosure norms and policies have an impact on the level of investor protection. The result of the chi-square test indicates that there is a strong influence of the additional disclosure norms and policies on firm value. The results are found to be significant at 1% level.

Chi-Square Test Result	Interpretations
39.51	Accept H ₁

The adoption of non-mandatory measures does have an impact on firm performance, and hence it can be stated that the adoption of these measures is in favour of shareholders and that such measures do influence the level of investor protection.

2.1.2 There is a no difference in the firm performance of companies meeting mandatory requirements and companies meeting mandatory requirements as well as adopting non-mandatory requirements.

Out of a total of 58 observations, 27 companies had adopted the use of the postal ballot and the whistle blower policy along with the other mandatory requirements. A Z-test was computed to test the difference in the firm performance of companies adopting only mandatory measures and companies adopting both mandatory as well as non-mandatory measures. Firm performance was considered for two financial years 2007-08 and 2008-09.

The result of the Z-test indicates that there is a difference in the firm performance of companies for having adopted the non-mandatory recommendations out of their own choice as against those who have only met the mandatory requirements. The results are found to be significant at 1% level and at 5% level for the two financial years respectively.

Z Test Result		
Year	2007-2008	2008-2009
Z- Score	2.509977	1.80403004
Level Of Significance	0.01	0.05
Interpretation	Accept H ₁	

It is interesting to note that the sampled companies besides adopting the mandatory requirements are moving a step ahead to adopt the non-mandatory measures. The use of postal ballot by the corporate sector to pass key resolutions is indicative of the active participation of small shareholders in the working of the company and recognizes the shareholders as true owners of the company. The adoption of the whistle blower policy is indicative of the important role of the employees and the adoption of ethical business practices in the organization.

3. Conclusion

The corporate sector in India has come a long way in adopting and the implementing the Code of Corporate Governance. This study comes to the conclusion that there is a gradually adoption of the code among the mid-cap companies as well.

Adoption of the non-mandatory measures is a positive sign; very often new legislation, new codes of conduct for organizations or new policies are often met with resistance and organizations express a feeling of 'having thrust upon'.

The use of postal ballot in passing key resolutions is an important observation made in this study. The companies are looking forward to more active participation and contribution of the large number of shareholders. The concept of corporate democracy is very often termed illusory in a country like India; this observation is indicative of the change in the way business is conducted in India.

With the adoption of the whistle blower policy, the changing attitude towards whistle blowing in the Indian corporate sector is palpable. Though whistle blowers have garnered much attention in the accounting scandals in the recent past, adoption and implementation of such a policy by organizations places the employees on a level playing field and granting them the privilege of approaching independent bodies and drawing their attention to unethical practices without having to inform the board.

4. References

- [1] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, (1998a), Law and Finance, *Journal of Political Economy* 106, 1113-1155

- [2] Johnson Simon, Peter Boone, Alasdair Breach and Eric Friedman (2000) “*Corporate Governance in the Asian Financial Crisis 1997-98*” *Journal of Financial Economics* 58 (1):141-86
- [3] Anthony Ogus (2004) “*The Importance of Legal infrastructure for Regulation (and Deregulation) in Developing Countries*” Centre on Regulation and Competition, Institute for Development Policy and Management, University of Manchester, Working Paper Series Paper No. 65 June
- [4] Kumar, Jayesh (2003) “Share holding pattern and Firm Performance” Indira Gandhi Institute of Development Research, Mumbai
- [5] Berkman Henk, Rebel A. Cole, Andy Lee & Madhu Veeraraghavan (2003) “The Effect of Board Composition and ownership Structure on Firm Performance: Evidence from India” University of Auckland, 2003