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The Effect of Corporate Governance on Profitability of a Firm: A Study of Indian Automobile Industry

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ABSTRACT

In the globalized era, a world class governance system is demanded by the corporate world. Corporate governance is about promoting corporate ethics, fairness, transparency and accountability. This study aimed at examining the impact of corporate governance on the profitability of Indian automobile sectors. The data required for the study was obtained from the annual reports of the select automobile companies. The obtained data was analyzed using correlation and OLS regression model, where profitability of the select companies was taken as dependent variable and board size, audit committee members, board meetings, non executive directors, directors remunerations as independent variables. And the study revealed that there is strong positive association between director's remuneration and profitability whereas the no of Audit Committee members and profitability of the firm are negatively correlated. In the study it was also observed that board size, board meeting and non-executive directorswere not significant association with the profitability.

KEY WORDS: Corporate governance, profitability, board size etc.

INTRODUCTION

Corporate governance is termed as the set of processes, customs, policies, laws and institutions, that affect the way a company is directed, administered or controlled. The Cadbury Committee of U.K. in January, 2000 defined corporate governance as – "the system by which companies are directed and controlled"

Corporate governance is an arrangement of structuring, operating, and regulating an organization to attain long-term key objectives to fulfill its shareholders, creditors, employees, clients and suppliers. Corporate governance assumes a paramount role for improvement of firm's profitability, which is vital for attaining the corporate goals.A good corporate governance is an essential tool in a developing countries like India,for globalization of business organizations. Good corporate governance comprises from claiming transparency principle, accountability principle, autonomy and impartiality principle, which have direct impact on the performance of the company. Good corporate governance does not only enhance the profitability but also increases firm performance.

Corporate governance is more concerned about the relationship among management, board of directors, controlling shareholders, monitoring shareholders and other stake holders. By enhancing the overall performance of companies and increasing their access to external capital, good corporate governance contributes toward economic stability that reduces the vulnerability of the financial crises. It reduces cost of capital and transaction cost.

Thus, corporate governance is important for all types of business entitiesCorporate governance is a key element for improvement of investors' confidence, increase of competitiveness and improvement of economic growth. Corporate governance is on the top of agenda for international development. According to James Wolf-ensohn(1998) "the governance of the corporation is now as important in the world economy as the government of countries".

Discussion on corporate governance started in early 80's during which American managers had neglected interests of shareholders which gushedinto fall of share price.

Work on corporate governance was carried by the Organization for Economic Co-operation and Development (OECD)for many years. In the best interest of their citizens all the Governments of OECD member countries

have interest to ensure good practice of corporate governance as a vital element in promotion of prosperity and economic growth. The first international code of good corporate governance approved by governments was published by the OECD as Principles for corporate governance in 1999. These Principles focused on publicly traded companies, and have a goal to help governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance. They also provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.

A good corporate governance can help to avoid corporate scandals, fraud, and potential civil and criminal liability of companies. Good corporate governance augments the image and reputation of a company and makes it more attractive to all the stake-holders of the company. Many researches have proved that good corporate governance produces direct economic benefit to the company, making it more profitable and competitive.

LITERATURE REVIEW:

In last few years corporate governance has become subject of the large interest in theory, as well as in practice. According to Parker(2007) "corporate governance has commanded the highest levels of attention and debate among legislators, regulators, professions, business bodies, media and in the general community". Despite existence of many different approaches and definition Cadbury (1992) broadly defined corporate governance,as "basically the system by which companies are directed and controlled". More accurately, it is the framework by which interest of various stakeholders are balanced, or as stated by the International Financial Organization (IFC)(2005) it "concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders".

The Organization for Economic Co-operation and Development (OECD)(2004) also defines corporate governance in its Principles of corporate governance as "A set of relationships between a company's management, its board, its shareholders and other stakeholders". It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined"

According to Global Reporting Initiative, (2013), The companies are required to disclose their governance structure in their corporate reports. The Standard Disclosures under Governance Aspect as per G4 Sustainability Reporting Guidelines by Global Reporting Initiative (GRI) include:

- Governance Structure and its Composition;
- Role of highest governance body in setting organization's purpose, values, and strategy;
- Competencies and Performance Evaluation of highest governance body;
- Role of highest governance body in Risk Management;
- Role of highest governance body in Sustainability Reporting;
- Role of highest governance body in evaluating Sustainability Performance;
- Remuneration and Incentives.

According to OECD (2004), "Structure of corporate governance determines distribution of rights and responsibilities between various players in company, such as boards, managers, shareholders and other stake-holders, and lays rules and procedures for making corporate decisions". This way, it provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The Ministry of Finance, Singapore (CORPORATE GOVERNANCEC 2001) opined corporate governance as "the processes and structure by which the business and affairs of the company are directed and managed, in order to enhance long term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders. Good corporate governance therefore embodies both enterprise (performance) and accountability (conformance).

Good corporate governance plays a vital role in enhancing integrity and efficiency of companies, along with financial markets in which company operates. Company's potential weakens with poor corporate governance and can lead a way to financial difficulties and frauds. Companies that follow the best practice of corporate governance generally raise capital easier and at lower price and in long term are more profitable and competitive when compared to companies that have poor corporate governance. Also those companies that insist on the highest standards of governance reduce many risks that arise from daily operations. Such companies are able, to attract investors whose investments could help finance further growth and development because of their better performance and returns.

Many recent researchesproved that investors have a tendency to invest more in companies which have better governance systems. Bushee, Carter and Gerakos (2007), &Leuz, Lins and Warnock (2007) also support this claim that investors exhibit preference for well-governed firms.

Merton (1987) argues that investors are more likely to invest in those companies that they know about. Based on the results of studies of Brennan and Cao, (1997); Kang and Stulz, (1997); Covrig, Lau and Ng, (2006); and Choe, Kho and Stulz, (2005) specified that foreign investors tend to invest primarily in those companies associated with less information asymmetry.

As per Report of the SEBI Committee on Corporate Governance, February 2003 - the fundamental objective of corporate governance is to enhance the long-term shareholder value, while at the same time protecting the interests of other stakeholders by improving the corporate performance and accountability.

In the words of Aras& Crowther(2008), Corporate Governance lays down the framework for creating long-term trust between companies and the stakeholders. Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits.

SEBI believes that companies having good corporate governance system in place are rewarded by investors and markets with high valuations. In practice, there are four principles of good corporate governance, which are: (1) transparency; (2) accountability; (3) responsibility; and (4) fairness

The corporate governance principles, when properly applied in the organization may increase the profitability and returns, improve its competitiveness, credibility and improve relations with key stakeholders such as investors, business partners, employees, customers, etc.

Todorovic, (2013) Kumar and Nihalani (2014) investigated the effect of corporate governance on the performance of Indian Banks and found that board of the directors has play significant role in firm performance but the board meetings negatively impact on the financial performance.

Latif et al. (2013) found that board size and CEO duality had significant impact on firm performance while board composition had insignificant impact on performance.

Todorovic (2013) found that if the company rigidly follows principles of corporate governance then it results in higher net profit margin and earnings per share.

According to Global Reporting Initiative, (2013), the quality of corporate governance basically depends on the following factors, which in turn affects the corporate performance(profitability).

- Integrity of management
- Size of Board
- Ability of board
- Frequency of Board Meetings
- Insider Trading and Whistle Blower Policy
- Quality of corporate reporting
- Stakeholder Engagement
- Independent Directors
- Board Committees - Audit Committee, Remuneration Committee, Nomination Committee, Investor Grievance Committee, Risk Management Committee, etc.
- Class Action Suits

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- Role and Rotation of Auditors

Abdullah (2006) studied the relationship among directors' remuneration, firm performance and corporate governance in the Malaysian firms and the study showed that directors remuneration was not associated with the profitability while the board independence and the extent of non-executive interests negatively influence the directors remuneration and also strong negative relationship was found between the return on assets and the directors remuneration.

Stephen and Olatunji (2011) studied the role of non-executive directors in the profitability and the study revealed that the non-executive directors and return on equity are negatively associated with each other. The findings show that more numbers of outside directors in board adversely impact the financial performance.

Garvey and Swan (1994) assert that "governance determines how the firm's top decision makers (executives) actually administer such contracts .

Shleifer and Vishny (1997) define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.

Laing and Weir (1999) establish a positive correlation between firm performance and audit committee using ROA.

In 2002 Weir et al. (2002) concluded that the existence of audit committee doesn't influence the firm performance (Tobin's Q).

RESEARCH PROBLEM

Corporate governance is the important factor in economic development. For business globalization economics, implementation of good corporate governance principle is necessary. Many of studies are being conducted in the context of corporate governance but no study was found to analyze corporate governance impact on the profitability in context of Indian automobile firms. On the basis of review of available literature in various national and international journals, a small number of study is found that focused over corporate governance components like audit committee members, non executive directors and board meetings. Thus the present study aims at analyzing the impact of board size, audit committee members, board meetings, non-executive directors, directors remunerations on the profitability of select companies of automobile industry.

Objectives of the study:

Based on the research problem the following objectives of the study are framed:

- To empirically study the relationship between corporate governance and corporate profitability over short term in an Indian context
- To examine the impact of corporate governance on the profitability on the India automobile industries.

Need for The Study :

Corporate governance is the way a corporation polices itself. In short, it is a method of governing the company like a sovereign state, instating its own customs, policies and laws to its employees from the highest to the lowest levels. Corporate governance is intended to increase the accountability of the company and to avoid massive disasters before they occur..

SCOPE OF THE STUDY

The study is limited to five companies, the data of annual reports for five years werecollected for the study. This study gives us a relationship between corporate governance and profitability in automobile companies.

SOURCES OF DATA

Secondary data has been used for the research purpose. Data has been collected from annual reports of the automobile industries**.** Five automobile companies which are listed in both Bombay Stock Exchange and

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National Stock Exchange have been selected as sample size. The data has been collected from annual report of five years ranging from 2011-12 to 2015-16

SAMPLE

Five companies of the automobile industry are taken as sample ,they are listed below:

- TATA MOTORS
- ASHOK LEYLAND
- MARUTHI SUZUKI
- HERO MOTO CORP
- TVS MOTORS

The annual reports of above listed companies are collected for five years.

TOOLS FOR ANALYSIS

There are number of variables which are used to analyze the impact of corporate governance on profitability,the different dependent and independent variables, used to analyze impact of corporate governance over profitability, and their measurement. Independent variables are the Board Size(BS), non-executive directors (NED) director's remuneration (DR), no of Board Meetings (BM) and audit committee members (ACM) which are measure the corporate governance. Dependent variable is the PAT which measure the profitability.

Since the data is of panel in nature consisting of both time series and cross sectional data, so that the ordinary least square panel regression (OLS) is used for the purpose of analysis

ANALYSIS AND DISCUSSION

The main objective of this study is to examine the impact of corporate governance on the profitability on the India automobile industry. Further, study also attempt to describe the corporate governance and relationship of corporate governance with the profitability. For achieving the research objective, following hypothesis has been tested

H_1: There is significantly positive association between board size and profitability.
H_2: There is significantly positive association between audit committee members and profitability.
H_3: There is significantly positive association between director's remuneration and profitability.
H_4: There is significantly positive association between board meetings and profitability.
H_5: There is significantly positive association between non-executive directors and profitability
To study the impact of board size, audit committee members, board meetings, non-executive directors, directors remunerations on profitability of firm five companies were selected from automobile industry viz Tata Motors, Ashok Leyland, Maruthi Suzuki, Hero Moto Corp, TVS Motors.

DESCRIPTIVE STATISTICS

Descriptive analytics simply describes the past using a range of data to draw comparisons. Most commonly reported financial metrics are a product of descriptive analytics e.g. year-over-year pricing changes, month-over-month sales growth, the number of users, or the total revenue per subscriber. These all describe what has occurred in the business in the time

Table.1 shows the Descriptive statistics of 5 select companies in automobile industry

	PAT	BS	ACM	DR	NED	BM
MEAN	1448.976	12.56	4.28	30.3676	9.32	6.52
MEDIAN	721.77	12	4	10.64	9	6
MAXIMUM	4738.95	16	8	134.51	13	10
MINIMUM	29.38	11	4	0.58	6	5
STANDARD DEVIATION	1496.392	1.193035	0.842615	43.39941	1.749286	1.50333
OBSERVATIONS	150	150	150	150	150	150

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Table 1 shows that total observations are 150. Presence of more than four members is essential to build a qualified and independent audit committee. Present study found that the presence of at least four members in audit committee in companies under sample. Whereas the board of directors meets at least five times in the year while the mean of the board directors meet more than six times. The part of non-executive directors in the board should be at least 50 percent. According to this sample the average of board size is 12.56 and the average of the non executive directors is 9.32 it means non-executive directors in board is more than 50 percent. The average of director's remuneration (DR) is Rs. 3.36crore and director's remuneration is Rs. 134.51crore to maximum extent. The minimum of the director's remuneration is the Rs. 58lakh. The maximum profit is Rs. 4738.9 crore and minimum amount of profit shows negative representing loss amounts to Rs. 29.38crore.

In statistics, **dependence** or **association** is any statistical relationship, whether causal or not, between two random variables or bivariate data. Thus to understand the correlation between the variables correlation was done using SPSS 21 and the matrix is shown in table.2

TABLE NO 2 : CORRELATION MATRIX FOR ALL VARIABLES

	PAT	**BS**	**ACM**	**DR**	**NED**	**BM**
PAT	1					
BS	0.21829	1				
ACM	0.28562	0.086212	1			
DR	0.364202	0.117035	-0.18612	1		
NED	-0.50967	0.509513	0.219362	-0.13121	1	
BM	0.08406	0.109654	-0.08684	-0.26768	0.187597	1

Table 2 displays the correlation matrix of all the variables. Except Non-executive directors(NED) in the board all other independent variables are positively correlated with profitability of the firm, which shows that the profitability of the firm increases with increase in the quality of corporate governance which primarily depend on the selected independent variables viz BS, ACM, DR, NED, BM etc.

Testing of Hypotheses: To test the hypotheses OLS regression analysis is done using SPSS 21, and the results are tabulated in table3.

TABLE NO 3: ORDINARY LEAST SQUARE REGRESSION RESULT

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	4431.722	3141.918		1.411	.175
	BS	-52.878	259.575	-.042	-.204	.841
	ACM	-156.343	325.348	-.088	-.481	.636
	DR	12.489	6.530	.362	1.913	.071
	NED	-403.190	180.855	-.471	-2.229	.038
	BM	265.186	185.073	.266	1.433	.168

a. Dependent Variable: PAT

TABLE NO 4: ORDINARY LEAST SQUARE REGRESSION RESULT

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.655[a]	.429	.279	1270.971

a. Predictors: (Constant), BM, ACM, BS, DR, NED

TABLE NO 5: ORDINARY LEAST SQUARE REGRESSION RESULT

N	150
Adjusted R-square	0.279
F-statistic	12.854
Prob(F-statistic)	0

Table 3,4,& 5 represents the result of ordinary least square model .The adjusted R2 0.279 for the model implies that more than 27 percent of the variance in profitability can be explained by the variances of independent variables. It is observed that the model is good fit because the prob (F -statistic) is less than 0.05

The results says that director's remuneration (DR) has significant positive impact on the profitability of the companiesimplies remuneration of directors positive impact on the profitability at 0.362 that is why hypothesis ($H_{3)}$ is accepted. This observartion from the study is in accoradance to the study by Karam Pal Narwal and Sonia Jindal(2015), but according to the studies of Abdullah (2006) directors remuneration do not have any impact on profitability of the firm. Whereas audit committee members (ACM) has significantly negative impact on the profitability thus hypothesis (H2) is rejected. Board size has also insignificant negative impact the profitability so that hypothesis (H1) is rejected which means the board size and profitability of the firm are not significantly associated. Non-executive directors have also significant negative impact on the profitability,thus the hypothesis (H4) is not accepted. This result is in line with the observation made by Stephen and Olatunji (2011) who found that the presence of non-executive directors do not have any impact on the PAT of the firm. On contrary to the observations of Kumar and Nihalani(2014), this study shows positively influence of number of Board meetingson the profitability thus H5 is accepted.

CONCLUSION

After liberalization, globalization and privatization only, the movement of corporate governance is observed in India.As the developingcountries like India face tough competition in the globalized business world, they need corporate governance concepts to face the challenges.

The aim of this study was to evaluate that corporate governance impact on the profitability of Indian automobile firms. The regression model was applied on the sample companies. The empirical result showed that the director's remuneration plays important role in the profitability. The correlation matrix also shows that director's remuneration has significant positive association with the profitability.

Large board size may not be in favor of the automobile industry because they do not increase the profitability. Board meetings also have a positive impact on the profitability but result is not statistically significant. It is can be concluded that, if the Indian automobile firms apply the good corporate governance principles then they can achieve the firm objectives and also the Indian firms can stand at the top all over the world.

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