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GOVERNANCE ROLE OF INDEPENDENT DIRECTORS ON FINANCIAL PERFORMANCE OF INDIAN LISTED COMPANIES: AN EMPIRICAL ANALYSIS

Dilip Kumar Pal*

ABSTRACT

The failure of giant firms such as Enron and WorldCom, led to a series of efforts for improvement of corporate governance which deals with the appropriate board structure, processes, and values to cope with the rapidly changing demands of both shareholders and other stakeholders in and around their enterprises (Garratt, 2003). A major requirement of corporate governance regulations is to increase the number of outsiders serving in the board of directors of the companies. This article briefly discusses the regulatory framework of India on independent directors of listed companies and also reviews some literature relating to role of independent directors on firm performance. Based on the sample size of 20 companies randomly selected from Nifty 50 companies for the accounting period 2018-19 we make an empirical study on the governance role of independent directors on the financial performance of the listed companies in India. The study finds no significant impact of the independent directors on the financial performance of the listed companies in India.

KEYWORDS: *Corporate Governance, Firm Value, Independent Director, Firm Performance, Companies Act, 2013.*

Introduction

In terms of clause 49 of the listing agreement, the board of directors of the listed companies in India shall have a balanced mix of executive, non-executive and independent directors. Separation of ownership and management control in a corporate entity tends to create several interested groups with diverse objectives and goals. The decisions and actions of such groups are generally self-beneficial devoid of achievement of overall organizational goals. In view of such conflicting interests a balanced view is essential for adequate protection of the interests of such stakeholder groups. The independent directors due to their presumed independence relative to the insiders are expected to have an objective and balanced view to protect the legitimate interests of different stakeholders. They can play a very crucial role in reducing the potential conflicts of interests of shareholders, management and the company which will ultimately go a long way in reducing the agency problems.

In the board's deliberations particularly on the issues such as strategy, risk management, resource allocation, key appointments, standards of conduct, the independent directors are expected to give their valued opinion, unbiased and balanced judgment free from any partiality and self-interest. Either as a part of the committee(s) or otherwise the independent directors also evaluate the performance of non- executive directors, chairperson of the company and the entire board. It should be made crystal clear that the position of independent directors is not merely a ceremonial one; rather their active participation in board's deliberations is very important in corporate governance practices and firm performance. This paper empirically investigates the role of independent directors of the listed companies in India in the financial performance as measured in terms of Return on Assets. In section 2 of the paper, we review literatures on governance role of independent directors in financial performance. Section 3 briefly describes the regulatory framework on independent directors for listed companies in India. In section 4, we analyze our sample and methodology. Section 5 gives the results of our analysis. Section 6 concludes the paper.

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* Ph.D. Research Scholar, The WB National University of Juridical Sciences, Dr. Ambedkar Bhavan, Salt Lake City, Kolkata, India.

Literature Review

A significant number of research works were done on the governance role of the independent directors towards improvement of financial performance. However, the studies which examine this correlation between the proportion of independent directors and the financial performance of firms produce diverse results.

Block (1996) finds that the positive relation between the firm financial performance and the percentage of independent directors tends to zero as outsiders increase. The author claims that, once the threshold for addition of an outsider is met, the firm should stop inducting any further additional outsiders.

Klein (1998) in her study "Firm Performance and Board Committee Structure" states that three monitoring committees of a board (Nomination, Compensation & Audit Committee) which are traditionally dominated by independent directors do not have any fruitful effect on firm performance, irrespective of their staffing manner. On the contrary, the author finds a positive correlation between the presence of inside directors on the board's finance and investigation committees and firm performance.

Lawrence and Stapledon (1999) report in their study that the proportion of independent directors has no influence on the company's managerial resources. Two studies carried out by Bhagat and Black (2000 and 2002) report negative relationship between board independence and shareholders' wealth. The authors argue that insiders of the firm have a positive effect on the firm value due to their knowledge and expertise on the operations of the firm. On the other hand, though there are no conflicts amongst the independent directors, they are relatively ignorant about the functions of the firm and tend to have minimal incentive to monitor due to their insignificant shareholdings.

The study conducted by Harley and Wiggins (2004) shows that in the companies where the earnings of the independent directors are based on equity based incentives, goal of independent directors are closely aligned with those of the shareholders, and automatically the shareholders' rights are better protected by those outsiders.

Ritchie (2007) states that an independent director does not have any lasting positive effect on share prices because once outsiders become directors they no more remain a third party to the firm and may start fighting for their best interest. The author argues that most outsiders lack experience and requisite expertise regarding the company's operations and in that circumstances, inside managers when serving on the board are more effective.

Bhagat & Bolton (2008) assert that independent directors negatively affect firm value and they should only be added to discipline the management in poorly performed firms. There will be a bad effect on shareholders' wealth by just adding outsiders on the board.

Duchin et al. (2008) point out that in case of firms which constitute their boards in order to maximize firm value, an increase in the number of independent directors on such boards would be harmful. On the contrary, if the firm managers constitute their boards with too few independent directors for the very purpose of minimizing oversight, an increase in the number of independent directors will be helpful in enhancing the oversight in such firms.

In the Indian context, **Fernandes and ECGI (2005)** argue that in order to foster the board's effective monitoring role, special attention needs to be paid to the role, quality, and integrity of their non-executive directors. Krishna (2006) finds no evidence to confirm any relationship between maximization of firm value and independence of board.

Kumar and Sivaramakrishnan (2007) assert that the firm value or corporate financial performance can actually improve when board is more dependent on CEO or the management team but decreases when more independent directors are in the board. The debate on the impact of governance role of independent directors on financial performance of firms is yet to be settled.

Regulatory Framework

The concept of "Independent Directors" was first sought to be introduced in the legislation through the Companies Bill, 2009 which was finally enacted in the form of the Companies Act, 2013 with several modifications. The new Companies Act, 2013 lays down in clear and unambiguous term, the requirements, duties, rights and obligations of independent directors. In case of listed companies, the additional requirements for compliance with clause 49 of the listing agreement have imposed stringent norms for the governance practices at par with best practices in the world. Clause 49 of the Listing Agreement was thoroughly revised by SEBI vide Circular Ref. No. CIR/ CFD/POLICY CELL/7/2014 DT 15/09/2014 and several changes were made in relation to the governance role of independent directors.

The SEBI had notified on 2nd September 2015 The SEBI(Listing Obligations and Disclosure Requirements) Regulations 2015 after repealing its 128 circulars issued during the period from 3rd April 1992 to 8th April 2015. The new Regulations *inter alia* incorporate several provisions on corporate governance norms as well as independent directors of the listed companies. It may be noted that our analysis is based on listed companies; hence we give here the extant provisions on independent directors applicable for listed companies under the following heads.

Independent Directors and Board Composition

The board of directors of the listed companies shall be composed of as follows:

- The board shall have a perfect mix of executive and non-executive directors with minimum one woman director and not less than fifty percent be non-executive directors. However, the boards of top 500 listed companies shall have at least one women independent director by April 1, 2019 and the top 1000 listed companies shall have a minimum one woman independent director by April 1, 2020 and such 500 and 1000 listed companies shall be determined based on market capitalization at the end of the immediately preceding financial year.
- If the chairperson of the board is a non-executive director, at least one third of the board members shall be independent directors and in absence of a regular non-executive chairperson, at least half of the board members shall be independent directors. However, in case, the non-executive chairman is the promoter of the company or is related to any promoter or to the person occupying the board level managerial position or at one level below the board, then at least half of the board members shall be independent directors.
- With effect from April 1, 2019, the board of top 1000 listed companies and with effect from April 1, 2020, the board of top 2000 listed companies shall have at least six directors and such 1000 and 2000 top listed companies shall be determined based on market capitalization at the end of immediate preceding financial year.
- Where the listed company has outstanding SR. equity shares, at least fifty percent of the board members shall be independent directors.
- A person cannot be appointed or continue his directorship as non-executive director in a listed company on attaining seventy five years of age unless a special resolution is passed to that effect by the listed company, in which case an explanatory statement is annexed to the notice of the meeting giving justification for such appointment.
- With effect from April 1, 2022, the top 500 listed companies shall ensure that the chairperson of the company shall:
    - be a non-executive director
    - not be related to the Managing Director or Chief Executive Officer as per the definition of relative under the Companies Act, 2013.

The top 500 companies shall be determined based on the market capitalization as at the end of the preceding financial year.

- An independent director of a listed entity shall not be less than 21 years of age.

Restrictions on Independent Directors

A person shall not serve as an ID in more than seven listed companies. Moreover, a whole time Director of a listed company shall not serve as an ID in more than three listed companies. The maximum tenure of the IDs shall be in accordance with the Companies Act, 2013. The Act provides that an independent director shall hold office for a term up to five consecutive years on the board of the company and shall be eligible for re-appointment on passing of a special resolution by the company and disclosure of such appointment in the board's reports. No independent director shall hold office for more than two consecutive terms. However, such ID shall be eligible for reappointment as an ID only after a 3 years' cooling off period, on completion of such two terms. IDs will not be entitled to any stock option of the company. A director can't be a member in more than ten committees and the Chairman of not more than five Committees across all the boards of Indian listed Companies in which he is director.

Sample and Methodology

Sample

The Companies Act, 2013, Clause 49 of the Listing Agreement and SEBI(LODR) Regulations 2015, cast tremendous obligations and duties on the independent directors toward proficient corporate governance practices of the listed companies in India.

The main objective of the present study is to make an empirical analysis on the governance role of the independent directors in the financial performance of the listed companies in India. With this end in view, we have selected the sample of 20 companies on a random basis out of Nifty 50 companies. Such companies are associated with the industries like automobile, cement, pharmaceutical, infrastructure development, information technology, steel, paints, health care, mobile networking etc. The data used for the study are collected from published annual reports uploaded in the respective websites of the companies, Prowess data base of CMIE and other relevant websites. The period of study relates to the financial year 2018-19.

Overview of Dependent and Independent Variables

Consistent with the studies made by Core et al. (2007) and Barbar and Lyon (1996), We have taken only Return on Assets (ROA) to measure the firm performance. The ROA is an indicator of efficiency of management in using the assets to generate firm's earnings. For the purpose of study we use four independent variables namely, % of independent directors in board (ID),% of attendance of independent directors in board meetings (ABM),% of attendance of independent directors in AGM (AAGM),% of attendance of independent directors in Audit Committee meetings(AAC) and three other variables i.e., Debt –Equity Ratio(DER),Market to Book Value Ratio (MB) and Sales Value(SIZE).The variables used in this study and their measurement are largely adopted from existing literature(Bhagat & Bolton, 2008; Jensen & Meckling, 1976; Weisbach,1988; Bhagat & Black, 2002;Daily et al.,2003).

In other words, previous empirical studies in the context of developed and emerging markets guided the selection of independent variables. For the purpose of study we use the variables as detailed in Table 1.

Specification of Model

We posit that the firm performance (ROA) depends on certain variables namely, % of independent directors in board ,% of attendance of independent directors in board meetings,% of attendance of independent directors in AGM ,% of attendance of independent directors in Audit Committee meetings, Debt –Equity Ratio, Market to Book Value Ratio and Sales Value. We use Multiple Regression Analysis to find out the role of independent directors on financial performance. Accordingly, our model can be expressed as:

$$ROA = \alpha + \beta_1(ID) + \beta_2(ABM) + \beta_3(AAGM) + \beta_4(AAC) + \beta_5(DER) + \beta_6(MB) + \beta_7(SIZE) + e_i$$

The symbols have their usual meaning. Based on the discussions in the preceding parts, the study is hypothesized as follows:

H_1: Proportion of independent directors in the board is significantly related to the financial performance.

H_2: % of attendance of independent directors in board meetings is significantly related to financial performance.

H_3: Attendance of independent directors in AGMs is significantly related to financial performance.

H_4: Attendance of independent directors in audit committee meetings significantly affects financial performance.

H_5: Debt-Equity Ratio of the firm significantly affects the financial performance of the firm.

H_6: Market to Book Value Ratio positively affects the firm's financial performance.

H_7: Sales value of the firm significantly affects the financial performance.

Following the approach of Bhagat and Black (2002), we use the Multiple Regression and SPSS 17 to carry out statistical analysis...

Results and Analysis

We present the results and findings of the study through different tables and interpretations. Table 2 relates to the descriptive statistics of variables used in the regression model. The results show that the independent directors comprise of about 55% of the total board strength and their attendance in board meetings is about 86%.

Similarly, their attendances at the AGM and audit committee meetings are about 78% and 90% respectively. Overall results give an indication of good participation in the governance initiatives by the independent directors.

Table 3 gives model summary of multiple regressions using ROA as dependent variable. Model is highly significant at 5 percent level. R square is also very high at .674 and adjusted R square is .485.

Table 4 gives the multi-collinearity statistics of the independent variables in the regression model. Results given in the Table 4 show that no evidence of multi-collinearity is detected among the independent variables, since the VIF value is within tolerable limit of less than 10 (Hair et.al, 1998).

Table 5 presents the results of regression analysis. The results indicate that the independent variables ABM and AAGM have negative impact on dependent variable (ROA) and their relationships are not significant. On the other hand, there is no negative impact of the independent variables, ID and AAC on the dependent variable ROA, but their relationships are also not significant. Among the variables, two factors, i.e. Market to Book Value Ratio (MB) is significant at 1% level and Debt- Equity Ratio (DER) is significant at 10% level.

Hence, among the hypotheses we accept only two hypotheses, i.e.**H_5:** Debt-Equity Ratio of the firm significantly affects the financial performance of the firm and **H_6:** Market to Book Value Ratio positively affects the firm's financial performance. We therefore reject other 5 hypotheses

The primary objective of our study is to examine the significance of governance role played by the independent directors on the firm financial performance of Indian listed companies.

The empirical study reveals that there is no significant relation between firms' financial performance (as measured by ROA) and any of the four corporate governance related independent variables, such as proportion of independent directors in board, their attendance at the meetings of board, audit committee and also at AGM. In India, the independent directors are appointed mainly for statutory compliance. The existence of a majority independent board, generally, has a positive impact on financial performance. But findings of the study suggest that proportion of independent directors has no significant relationship with financial performance of the sample companies. The attendance of independent directors at board meetings is also not significant for better financial performance; rather the former exerts a negative impact on the latter. One of the reasons for this might be that the increased participation by the independent directors at the board meetings causes delay in the decision making process. Moreover, the independent directors have no pecuniary interest in the company except their token remuneration as permitted by law. The attendance impact of independent directors at AGM is negative and also insignificant as revealed by the study. The primary role of the Audit Committee is the oversight of company's financial reporting process and disclosure of the financial information to ensure that the statement is correct, sufficient and credible. The independent directors chair the Audit Committee meetings and they are majority members of the committee. So, their attendance at the meetings of the committee to comply with statutory requirements is likely to have a positive impact on financial performance. But results indicate that the impact of both the variables is not significant.

Overall, the results indicate that corporate governance performance as measured through certain independent directors related variables has very little role on financial performance of sample companies. The empirical findings of earlier studies do not support the contention that the independent directors have positive role on financial performance. (e.g., Cotter and Silvester, 2003). Our study confirms such findings in Indian context. However, we have found the significant role of MB ratio (significance at 1% level) and Debt- Equity Ratio (significance at 10% level) in explaining better financial performance of sample companies.

Conclusions

Independent directors need to add value to the company in terms of their ability to provide inputs on strategy, business, marketing, legal compliance or other relevant aspects and also carry out monitoring functions (by acting as watchdogs) in order to protect the interests of all the stakeholders and consequent improvement in firm financial performance as well as enhancement of firm value on a sustainable basis. Our empirical study does not provide any evidence on the significance of governance role of independent directors on firms' financial performance.

It may be appropriate to mention certain limitations of the study so that its results are not generalized. The limitations of the study are the smallness of sample size and short period of study (being restricted to the financial year 2018-19). More comprehensive research is needed in this area to explore the causal relationship between firm performance and independent directors' role so that the independent directors can play a significant role in the firm financial performance and also value creation for shareholders. Any future research may concentrate on role of corporate governance through independent directors on shareholders' protection, risk management, mitigation of financial distress etc. One may also explore dynamic relationship between proportion of independent directors and the firm performance to find out whether there exists any optimum number or proportion of independent directors for any board. Despite limitations, it may be hoped that the findings of the study may serve the purpose of managers and board members to decide on induction of independent directors and related issues. Policy makers may use the results of the study in fine tuning regulatory prescriptions in corporate governance matters.

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Table 1: Definitions of Variables

Explanatory Variables	**Definitions**
Return on Assets(ROA)	Earnings Before Interest & Tax/Total Assets
% of Independent Directors in the Board(ID)	% of total no. of independent directors on the total board strength
% of attendance of independent directors in board meetings(ABM)	% of actual attendance of independent directors in board meetings on the total strength of independent directors
% of attendance of independent directors in AGM(AAGM)	% of actual attendance at AGM by independent directors as against their total strength
% of attendance of independent directors in Audit Committee meetings(AAC)	% of actual attendance at Audit Committee meetings by independent directors out of their total strength in the audit committee
Debt- Equity Ratio(DER)	Loan Fund/Shareholders' fund
Market to Book Value Ratio(MB)	Ratio of firm's market value to its book value which is the proxy for growth
Sales value(SIZE)	Natural logarithm of firm's sales value

Table 2: Descriptive Statistics of Variables

	Mean	**Std.Dev.**
ID	55.37	10.77
ABM	85.81	08.67
AAGM	77.73	26.93
AAC	90.10	10.49
DER	00.25	00.40
MB	08.23	11.55
SIZE	10.14	00.75

Source: Annual Reports of sample companies. Results computed.

Table 3: Summary of Multiple Regressions

	Sum of Squares	**df**	**Mean Square**	**F**	**Significance (P-value)**
Regression	1700.137	7	242.877	3.552	.026*
Residual	820.627	12	68.386		
Total	2520.764	19			

Source: SPSS Output.

Significant at 5% level
Dependent Variable: ROA
R^2 =.674 & Adjusted R^2 = .485

Table 4: Collenearity Statistics

Variables	Tolerance	VIF
DER	0.521	1.918
ID	0.707	1.415
ABM	0.433	2.309
AAGM	0.641	1.56
AAC	0.619	1.614
MB	0.651	1.536
SIZE	0.82	1.22

Source: SPSS output.

Table 5: Coefficients and t-values

Explanatory Variables	Coefficient	t-values
Constant	8.327	0.164
DER	-13.672**	-2.083
ID	0.137	0.652
ABM	-0.293	-0.883
AAGM	-0.122	-1.392
AAC	0.218	0.948
MB	0.654*	3.212
SIZE	0.97	0.346

Source: SPSS Output

*Significance at 1% level, **Significance at 10%level.

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