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Impact of Board Independence on Firm Performance: A Comparison of Private Sector Firms with State Owned Enterprises in India

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1. Background of the study

Government of India (GOI) has undertaken several reform measures to improve the profitability and efficiency performance of state owned enterprises (SOEs) in an attempt to make them competitive vis-à-vis private sector firms. One of the recent ones to be added to this series is the implementation of the *Guidelines for Corporate Governance*[3] for all central government owned SOEs, with the belief that adopting good governance practices would not only protect the interest of the shareholders but also help the SOEs to become competitive in accessing capital markets for their funding requirement.[4] Though these guidelines covered all the SOEs under their purview, the SOEs that were listed with the Indian stock exchanges were expected to comply with the SEBI guidelines on corporate governance regulations under Clause 49 and hence were exempted from any additional norms under these guidelines. The Clause 49 of 'listing agreement' *inter alia* included the norms relating to definition, role and responsibility of board of directors. All listed firms irrespective of ownership type were expected to comply with Clause 49 by 2006.

Board of directors is considered as one of the most important internal control mechanism of corporate governance. Seen from the perspective of principal-agent framework (Fama and Jensen, 1983; Jensen and Meckling, 1976), the problem arising in modern corporations due to the separation of ownership rights of the principal (shareholders) and control of the firm by the agent (managers; for e.g. CEO/CFO etc.) is seen to be mitigated to a large extent by the board of directors. But, why does the

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3 The first guidelines were issued on experimental basis in 2007 in the report on Guidelines on Corporate Governance for Central Public Sector Enterprises (2007).

4 Guidelines on Corporate Governance for Central Public Sector Enterprises, 2010

Note : SEBI Listing Obligations And Disclosure Requirements Regulations, 2015 was not in effect when this paper was written.

problem arise in the first place? The problem arises because the managers may gain by pursuing actions to benefit their own interests at the cost of the interest of shareholders as they have an advantage over the shareholders due to their firm-specific expertise and operational knowledge of the firm (Mizruchi, 1983). The role of the board of directors is to act as custodians of the owner's interest; i.e. to act on behalf of the shareholders, monitor and control the management to achieve better firm performance.

The role of board of directors, as argued by many (like Fama, 1980; Weisbach, 1988; Sarkar, 2010) is more effective when the board consists of outside directors—particularly, independent directors. The public policy in India also highlights the importance of independent directors in SOE boards. In 1997 under the common minimum programme, one of the important preconditions established by the government for granting enhanced autonomy and delegation of power to some of the large and important companies like the "Navratna" companies was that the boards of these firms be restructured to include at least four non-official or independent directors[5]. While the best practice norms in corporate governance structure of SOEs was initiated in 1997, a more comprehensive guideline on corporate governance of SOEs was issued by GOI a decade later in 2007.[6] These guidelines were experimental in nature and the adoption of the guidelines by the SOEs was voluntary.

In 2010, the final draft of the corporate governance guidelines for SOEs was adopted. It was made mandatory for all SOEs to follow these norms. However, the listed SOEs were exempted from any additional norms as they already had to comply by the corporate governance norms set in Clause 49 of 'listing agreement' of the exchanges. The non-listed SOEs now had to comply by the norms set under the new CG guidelines of 2010. Several years have passed since the corporate governance reforms have been implemented in the SOEs and private sector firms in India. Scanning the empirical literature, we find studies that have analysed the impact of adherence to these norms on the performance of private sector firms in India.[7] The present study analyses the

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5 DPE OM No.DPE/11(2)/97-Fin. dated 22nd July, 1997, (1997) Turing selected Public Sector Enterprises into Global Giants – Operational and Administrative modalities – Restructuring of the Boards., Department of Public Enterprises, GOI; also downloadable at: http://dpe.nic.in/e_documents/archives/Guidelines/navmini/nm4 as on July 2016.

6 Guidelines on Corporate Governance for Central Public Sector Enterprises (2007)

7 For detailed literature review regarding various components of corporate governance reform particularly for India, see Sarkar and Sarkar (2012).

impact of these reforms on SOE performance in the Indian context. *The objective of the present study is to compare the impact of board independence on the performance of SOEs and privately owned firms in the Indian context.*

2. Research Design

The data for the study is sourced from Prowess, a database created by the Centre for Monitoring Indian Economy (CMIE). The sample includes SOEs that are listed on the Indian stock markets. The SOEs here include all the central government owned companies where the central government is a major shareholder (equity shareholding exceeding 50%). As of 2013, 46 SOEs were listed on the Indian stock exchanges (NSE and BSE). Of the 46 SOEs, data was available for 44 SOEs in Prowess. These listed SOEs form the scope of our analysis. A sample of listed private sector firms belonging to the same industries as SOEs was included for the analysis. The period of study selected is 2006-2013, with 2006 being the year of compliance for listed firms to Clause 49 of listing agreement. A total of 154 firms were included in the sample with 1,023 firm-year observations.

The impact of board independence and appointment of government nominee directors on firm performance measured by market based indicator 'market to book value ratio' (MBVR[8]) and accounting performance measure ROS ('return on sales', i.e., profits as a percentage of sales which is a backward looking accounting indicator) was examined. Other firm characteristics that might impact the firm performance were also included in the analysis.

3. Results

Our study indicates mixed results across performance measures and across ownership groups. The average impact of having independent directors on company boards is seen to improve ROS for both ownership groups (SOEs and privately owned). We also find that there is no significant difference in the improvement of ROS when SOEs or privately owned companies appoint independent directors. For the market indicator (MBVR performance measure), the impact is positive for private sector firms

8 Defined as the ratio of the product of number of equity shares and average closing price of the share for the financial year to book value of equity and reserves.

and significantly negative for SOEs. One probable reason for this is that independent directors in SOEs are not perceived to be independent. It is open to future research to investigate the background of the independent directors in the SOEs and their ‘true independence’. Further, the study finds that there is higher negative impact when the SOE boards appoint government nominees on their boards. Thus the market seems to discount this inclusion of government nominees on the boards of SOEs.

In light of the results of this study, where we find that the market seems to discount the performance of SOEs having government nominee directors on their boards and indeed, perceives the presence of nominee directors on SOE boards as a negative signal, the Central Government must reconsider its policy of appointing nominee directors in SOE boards. Inclusion of such directors can come in way of the government’s signal to the market that it is trying to professionalize the boards of Indian SOEs.